Geometrica Fund

Investor Newsletter – November 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 November +0.1% (Founders Class - Lead Series) with NTA at $1.0209 per unit.

At month end, gross exposure (the absolute sum of long and short equity positions) represented 29.3% of Fund net assets.

The portfolio as it presently stands consists of 10 positions; 9 longs and 1 small short.

Markets were white hot in November, with total return indices for the S&P500 and ASX200 both rising over 3% in local currency terms.

A fall of 11% in one of our holdings muted the otherwise solid performance of our fledgling long book.

Our approach continues to be to focus on picking stocks that we assess as having significantly more upside than downside risk.

If we are correct in this approach, and don't dilute those efforts by succumbing to the ever-present temptation to chase what's "hot", our experience has been that we will be rewarded with investment performance.

Stick to the knitting we shall.

Portfolio notes

GrubHub Inc.
(Ticker: GRUB.US, US$4.2bn mkt cap)

We closed out the vast bulk of this short early in the month.

Our sense is that the stock is still subject to a price discovery process. GRUB's underlying sales mix is shifting at a breakneck pace which we think is driving down margins and earnings .

GRUB has rallied hard off its lows post the 3Q 2019 result.

Should the rally continue we may yet get a second bite at the cherry.

If the data changes, however, reflecting an abatement of competitive intensity that implies total food sales are more likely to grow than decline, then we will change our view.

Sezzle Inc.
(Ticker: SZL.AU, mkt cap A$438m)

SZL's stock price fell 11% during the month, raining on our parade.

At the time of writing, with SZL at $2.20, 8% lower than where the stock price closed at the end of November and 3.2% below our average entry cost.

Detaching ourselves from the price action and focusing on the business, datapoints emerged during November which were positive in regard to SZL's operating performance and consistent with our thoughts on how the story will play out.

Black Friday & Cyber Monday

Given the importance and sales materiality of the four-day trading period in US retail bookended by Black Friday and Cyber Monday (BF / CM), SZL made an announcement to the ASX on 9 December 2019.

Leading up to this announcement, using a data source we reference, we were able to see that the incidence of *online* customers utilising SZL on BF / CM was actually slightly *greater* than those using Afterpay or Klarna.

The sample size in question appears sufficiently large to be reasonably representative. It does of course omit the instore checkout, where SZL lags Afterpay to date.

Nonetheless it is extremely encouraging as while Afterpay has larger average underlying merchant sales (UMS) per merchant than SZL does, they both have a similar average basket size per active user of ~US$80. Further, SZL's 5.2% merchant rate, which drives its revenue margin, is higher than our estimate of Afterpay's US merchant rate.

SZL added 36,000 new users across the four-day period representing 16.8% of the total quarterly net adds in 3Q19 and produced $11.3m of UMS representing 16.4% of the total quarterly UMS in 3Q19. This implies a 450% increase in BF / CM sales on the same period in FY18.

On a comparable time frame, 36 months into its listed life, APT experienced 204.2% YoY growth in UMS.

SZL's monthly UMS growth is currently a close-to-perfect second-order exponential function. We would be ecstatic to see 450% yoy growth in UMS in 4Q19 as this would imply ~670% yoy UMS growth for FY19.

Forward expectations and data

We expect SZL to grow UMS by ~443% yoy for the 4Q 2019 period based on data that we are observing.

Interestingly, we have seen a number of high-profile merchants start to feature prominently in SZL's online sales volume. Greyhound travel and Bass Pro, to call out two, appear to be transacting particularly well.

During November, SZL formally launched its operations in Canada. Based on data we track SZL actually entered Canada two months ago; probably on a soft launch basis.

For the month-on-month period between October and November, we estimate that Canadian UMS grew by 27.3% which is an effective annual rate of 1,711.1%. It's off a low starting base, but the virality of growth is exactly what we want to see.

Overall, on all measures, SZL continues to reach new peaks in terms of audience engagement.

Right now, Sezzle does not appear compellingly cheap vs its larger comparable on *consensus* forecasts.

Consensus: EV to revenue comparison: SZL v. APT		
Y/end December	**2019**	**2020**
Sezzle (Consensus)	20 x	11 x
Afterpay (Consensus)	26 x	16 x
SZL disc to APT (Consensus)	(23)%	(29)%

Source: Bloomberg. Afterpay adjusted to December year end.

It seems rational that at this juncture SZL should trade at a 20%-30% discount to Afterpay given the latter is profitable and of much larger scale.

But we think the consensus forecasts on SZL are *way* too low, driven by an extremely pessimistic perspective on second derivative UMS growth.

Corroboration of our perspective to date comes in the form of a recent material consensus upgrade to 2019 revenue, in the final month of the year.

Sezzle revenue forecasts (US$m)			
Y/end December	**2019F**	**2020F**	**2021F**
Consensus (in August)	11.3	22.5	38.9
Consensus (in December)	14.7	26.8	47.4
Upgrade	***30%***	***19%***	***22%***

Source: Bloomberg.

For the 2020 year, our SZL revenue forecasts are *materially* higher than consensus.

Given consensus upgraded 2019 revenue by 30% with a quarter to go in the year, yet only upgraded 2020 by 19%, you get a feel for the entropic growth decay in second derivative sales growth the consensus numbers imply.

On our numbers SZL is trading at a *massive* discount to Afterpay on 2020 forecast revenue; and over time that spills over to other metrics.

A was the case with Afterpay, we think SZL will traverse a period of revenue growth surprise, initially widening losses resulting from that and then clearly positive earnings momentum and a shift to profitability.

The implication is that we are at the start of a powerful upgrade cycle.

As an opener to that, our numbers imply that consensus revenue forecasts for SZL across 2020 will need to double.

Geometrica: EV to revenue comparison: SZL v. APT		
Y/end December	2019	2020
Sezzle (Geometrica)	20 x	5 x
Afterpay (Consensus)	26 x	16 x
SZL disc to APT (Consensus)	(23)%	**(68)%**

Source: Bloomberg, Geometrica. Afterpay adjusted to December year end.

In 2017, when we were buying Afterpay with our ears pinned back at $2.50 a share we held a similar view on an emerging upgrade cycle.

In early 2017, the consensus June 2020 revenue forecast for Afterpay stood at $168m.

Today it's $500m. Consensus was forced to upgrade by nearly 200% across this timeframe.

Time will tell if we're right on SZL.

If our 2020 revenue forecast for SZL is on the money, and the consensus 2020F revenue multiple holds, then all else equal, SZL's stock price should double in 2020.

Corporate Travel Management Limited
(Ticker: CTD.AU, mkt cap A$2.4bn)

CTD has grown to become one of our larger holdings. The stock rallied 17% during the month, in which an AGM provided - at best - muted guidance, indicating market expectations were overly pessimistic.

We remain a holder.

Nintendo Co Ltd.
(Ticker: 7974.JT, mkt cap US$53.5bn)

We acquired a long position in Nintendo during November. Originally founded in 1889 as a trading card company, Nintendo subsequently pursued multiple industries including taxis, love hotels, instant rice and TV networking before the 1970s when Nintendo became the video game company we know today.

Nintendo makes money from the sale of both video game consoles and video games. Games are typically sold on either a first- or third-party basis. First-party games are those that the company develops themselves while third-party games are developed by external companies engaged via a milestone-based contract.

Nintendo's current generation gaming platform, the Nintendo Switch, represents 85% of group revenue with the remaining 15% from the 3DS and the newly launched Nintendo Switch Lite.

Nintendo tends to trade as a cyclical stock. The cycle starts with low margin hardware (consoles) dominating sales and ends with high margin software (games) dominating.

Group margins transition positively as hardware unit margins improve through operating leverage and as the number of available games increases driving a higher tie rate and correspondingly higher overall margins.

In Nintendo's case, the average gross margin for software sales is ~75% for first-party games, 60% for third-party games and 15% for hardware sales.

Based on these unit economics, we expect peak gross margins of 55 – 60% versus ~48% currently. This is, in the context of Nintendo's margin history, a big call, and should be aided by a growing mix of online game downloads.

In the current cycle, Nintendo's hardware margin is mature at 15% and gross margin came in at 48% in the last quarter.

With 34 months having passed since the Switch console launched and gross margins sitting at historical highs, many market participants are likely "standing close to the door" assuming that this cycle is nearing its peak.

We think that the opportunity for the Switch is longer dated, implying a longer and stronger cycle than Nintendo has historically experienced.

The drivers of this are sell-in data we track, a very strong game release schedule and the potential of the recently announced entry into the Chinese market in partnership with Tencent (700.HK).

If this is correct, and Nintendo's current cycle really is "stronger for longer", then we should get confirmation in guidance early next year.

Data

The data that we are observing indicates that Nintendo stands to beat consensus' unit sales expectations by over 20% next quarter.

This is driven by growth in hardware and software sales in existing markets.

Comparison to Sony's Play Station 4

The current generation Sony PS4 has been the Switch's main competitor and is the second-best selling console gaming platform of all time with current lifetimes sales of 104 million units.

The Sony PS4 was launched in November 2013 while the Switch was launched in March 2016 and on an apples-to-apples time comparison, the Switch is currently behind in sales by just 645k units.

But, throughout the comparable 34-month window, the Switch has had only two holiday sales periods to the PS4's three since the PS4 was launched in November whilst the Switch was launched in March. So, the trailing 34-month performance, which favours the PS4, is massively skewed and the Switch, on an adjusted basis, is actually out-selling it.

On this basis, we estimate that consensus' cumulative earnings forecasts attributable to the Switch platform are missing just over 30% of the total sales potential inclusive of software sales.

First-party release schedule

First-party releases are the lifeblood of the Nintendo franchise, due to their focus on proprietary video game characters as individual brands or franchises – think of Mario as a figurehead for the Mario franchise or Pikachu as a figurehead for Pokemon.

This is different from smash-hit titles on Xbox and Play Station that do not have cohesive, character driven leads such as Call of Duty, NBA 2K19 or Uncharted 4: A Thief's End.

There are two proofs that first-party games are key to Nintendo's success. Firstly, the Nintendo Switch was launched during the peak sales period of the PS4 and yet, managed to outperform which proves that the core player-base is fundamentally different and/or that Nintendo's exclusive games are worth buying a new console to play.

Secondly, on average 80% of Nintendo's software revenue mix comes from first-party titles and 20% third-party. This is in stark contrast to Xbox and PS which generate 20% of software revenue from their inhouse first-party titles and 80% from external third-party game developers.

So, in the context of our thesis, it is key that we are able to observe a strong first-party release schedule. We have dug into all of the video game producing subsidiaries of Nintendo and can see that they have strong video game release pipelines. On top of that, the number of employees in these entities continues to rise in areas suggestive of an ongoing focus on game releases.

A few games in particular should drive unit sales next year, namely; Pokemon Sword and Shield (PS&S), Xenoblade Chronicles 2, a potential Mario Kart 8 sequel (Nintendo has never released two Mario Kart games on one platform so this would be a bullish signal) and Zelda Breath of the Wild 2.

PS&S's debut on the 15th of November seemed to vindicate our thesis as it was the best software launch in the company's history. Sales in the first two days totalled over 3 million units and drove record monthly hardware sales during November. For context, the best-selling game on the Switch has sold a total of 19 million units since its release 32 months ago.

We have found proxy data that appears to share a statistically significant relationship with game sales, and we will continue to monitor this in the lead-up to key releases.

The China opportunity

Some time ago, Nintendo publicly announced a partnership with Tencent to try and bring the Switch console into China.

This was largely ignored by the market at the time and we think this is because the Chinese gaming market has never embraced consoles, opting for PC based gaming instead.

Two months ago, we came across data that suggested that the official launch of the Nintendo Switch in China was imminent and based on our analysis, we saw this as a blue-sky opportunity not priced into the stock.

SKU Placeholder for the Switch, retrieved from a prominent Chinese online merchant

Last week, Nintendo officially announced that it had achieved approval from Chinese authorities to launch the Switch, which was relatively well received by the market.

The Sony PS4 has lifetime sales of just 1.5 million official units in China, only 1.4% of their global unit sales. This is likely because console gaming was banned in China in 2000, with that ban only being lifted in 2017.

The PS4 was the very first console released in China since lifting the ban and as such, there was no established market for it.

The Chinese gaming market has historically been dominated by PCs and mobile devices with only US$1bn of the US$37.9bn gaming industry revenue in 2018 being attributable to consoles. The Switch may be a good fit here since it can be plugged into a TV like a traditional console or can be hand-held like a mobile device with its integrated screen.

Similar to the rest of Nintendo's business, growth in the Chinese market will be driven by first-party releases. The Switch only launched in China with one available game, Mario Kart 8 Deluxe, but Nintendo recently highlighted nine other first-party titles which are close to release.

We understand that the delay here may be because Nintendo cartridges contain Denatonium Benzoate, a "bittering agent" added to stop small children chewing on them, which is still pending approval from Chinese authorities.

Overall, China is a blue-sky opportunity in our view. If Nintendo is able to gain even moderate traction in this market over the coming months, then the cycle will be extended beyond our presently bullish view, and further upside should present itself.

Growth stock

(mkt cap >US$1bn)

We've initiated a small position in a foreign listed growth stock that has suffered a large price fall of late.

The stock is liquid and listed on a major occidental bourse. We envisage building the position over the next one to two quarters; hence the anonymised discussion.

While the potential for a mean reversionary bounce in the stock's price is apparent over the next year and sufficiently compelling to warrant a modest exposure now, the real attraction here is the stock's longer dated capacity to compound its earnings growth and thus share price.

The business has a market cap in excess of US$1 billion yet is in the very early stages of its life cycle.

Unit economics within the business are highly attractive; incremental return on invested capital is a multiple of the cost of capital.

More impressively, rapid capital deployment is possible without the use of debt, as organic capital generation and working capital dynamics combine to allow internal funding of new investment at a torrid pace.

Because of the company's early stage of development and typically lofty valuation, the market seems to oscillate between periods of euphoria over the long-term potential of the franchise and periods of existential doubt and fear that it might all just fall apart.

We have entered a period of doubt currently.

Margins are compressing. A slowing in a core sales channel appears imminent.

There are four drivers of these negative developments. We assess that they are all transitory. Once cycled, the business will structurally have higher returns. But in the short-term earnings growth will slow relative to expectations, and so the stock will likely fall further.

One cause is exogenous cost inflation. We've seen these cost cycles before in this industry. Because the business has historically demonstrated pricing power, we feel we can look through this.

The other three drivers of earnings pressure are in fact management driven. Specific actions have been taken that increase cost and disrupt revenue flow in the near term.

Yet these actions are all accretive to longer term value. Nonetheless, in the short term, earnings will be impacted.

Our experience is the market will not look through this impending slowing in earnings growth.

We may yet get a chance establish a decent sized and well-priced position by buying into the teeth of a decent sell off.

19 December 2019.

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

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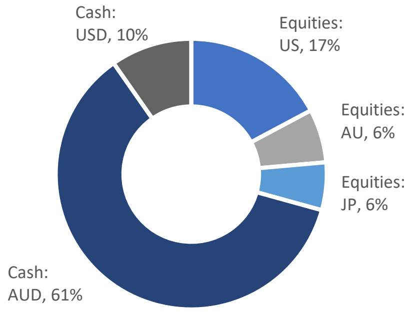
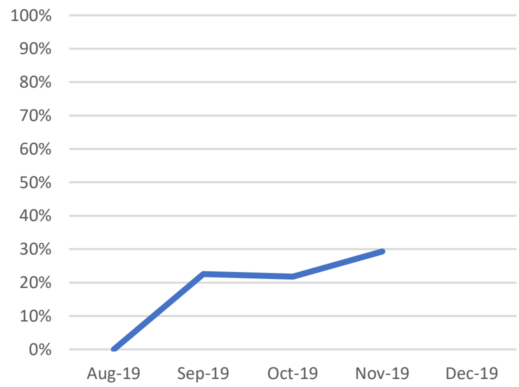
Asset allocation at month end



Gross exposure at month end



Investment performance (net)

	Founder Lead Series - 2019
Jan	-
Feb	-
Mar	-
Apr	-
May	-
Jun	-
Jul	-
Aug	-
Sep	1.1%
Oct	0.8%
Nov	0.1%
Dec	

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