

QUARTERLY REPORT #20: PERIOD TO 30 JUNE 2021¹

Performance and net asset value²

Quarterly gross portfolio return: (6.2%); fiscal year gross return +33.6%

Our portfolio has tended to react inversely to short term movements in markets over the quarter, doing well in May but less so in April and June when stocks were stronger. In turn, this reflects our exposures to more esoteric securities which – with some exceptions – have generally been exposed to the “value/reopening” end of the spectrum, which has lagged over the past quarter (eg. Dow Jones Industrial Average +4.6% versus NASDAQ100 +9.5%) and especially over the past six weeks since 13 May. The quarter really encompassed three periods:

- End March to early May 2021 when indices rose steadily;
- a very shaky period in the first two weeks of May culminating in a sell off around the release of the US April CPI and moves in ten year bond rates up to 1.7%; and
- a calming final six weeks when the extremely bearish sentiment and positioning in respect of US bonds was unwound – the yield falling from 1.7% to 1.48% at June month end – which resulted in some astonishing rebounds in growth/momentum/technology stocks.

Three examples from our short-sale portfolio show the extent of these extreme - and in two cases detrimental - moves in “high-growth” stocks, as the bearishness in bond markets unwound:

- Afterpay (ASX: APT) which ended March at \$101.50, rose to over \$127 by mid-April, fell back to a low of \$84.50 on 13 May and then rallied ~40% to \$118 by quarter end; we profitably covered our short in the low \$90’s;
- ARK Innovation ETF (ARKK) started the quarter at \$120, rose to \$128 by late April, collapsed to \$99.50 in 12 trading days to 13 May and then ascended virtually unchecked by 31% to \$131 by end quarter as its underlying investments rose; and
- Trupanion (TRUP), the pet insurer, started the quarter at \$76, meandered around to \$75 by 13 May, showing no reaction to a first quarter result with widening losses, then rose 53% to \$115 in six weeks.

Hence, in June, all five of our worst contributors were short positions in bouncing growth stocks. To assist in your understanding of why we short sell some of these companies, this report features a lengthy assessment of Sezzle, an ASX listed BNPL operator based in the USA.

Under these circumstances, such abrupt moves aren’t usually replicated in “value” stocks. An excellent example is the Norwegian company, Treasure ASA, whose only asset is some cash and a holding in Hyundai Glovis. Its shares are down 4.3% over the quarter, whilst Glovis has risen 11.5%; as a consequence, the discount to NAV is now over 45%.

¹ Readers are referred to footnotes 2 and 33 - 38 explaining the derivation of the numbers. All returns are pre-tax unless stated otherwise. At the current level of net assets, cost imposition is estimated at 0.9% per month over the course of a full year (excluding capital raising related expenses) and is fully accrued monthly according to the best estimates of management. Readers are explicitly referred to the disclaimer on page 22.

² Month by month tabulation of investment return and exposures is given on page 21, along with exposure metrics.

All in, when it's as good as it gets?

My belief that this is close to “as good as it gets” for equities and that folks are “all in” is growing in conviction.

In the past quarter, the S&P500 rose 8.2% and has gained 14% in the first six months of CY21; the NASDAQ 100 increased 9.5% in Q2 and is up 12.5% for the year. However, the erratic manner of equity performance in the June quarter perhaps offers some portends as to how markets may “correct”.

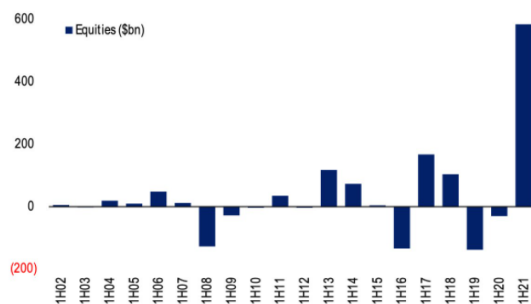
Anyone looking at co-incident indicators would be surprised at our caution. We are about to enter a quarterly reporting period in the US which will be the strongest quarter of earnings growth (64%) since Q4 2009³. Of course, there is an enormous “base effect” from the worst period of COVID in 2020, but S&P500 CY21 earnings in the US – which have been the subject of consistent upgrades through 2021 – are currently forecast at 191, compared to 163 in CY2019⁴. It should be acknowledged that I have been too cynical about this progression.

Moreover, the world is opening apace – apart from Australia and New Zealand where strategic errors of COVID vaccine ordering and roll-out schemes are crimping growth and consumer confidence; the fact Australia seems to have splintered into 8 separate countries and has a Federal election due in ten months is an additional burden.

It's hardly surprising people's psychological state is improving around the world, but the manner in which has been manifested in financial markets in the past six weeks is quite stunning. Everyone's a buyer of everything – bonds, oil, stocks, property and even bottom fishing in crypto. Consider these two charts from Bank of America Global Investment Strategy showing the magnitude of first half of CY21 inflows to equity funds against prior first halves – and the outstripping of the past twenty years first halves over the past six months:

Chart 3: H1 annualized inflow to equities largest ever

Equity flows in H1 (\$bn)

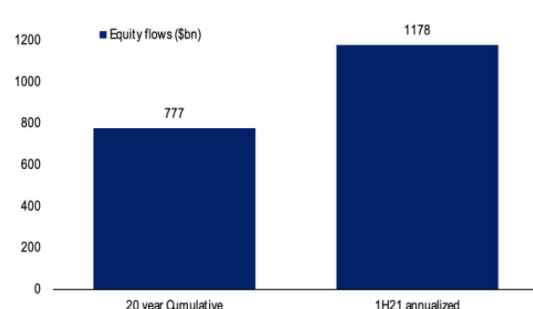


Source: BofA Global Investment Strategy, EPFR; note H1'21 is annualized

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Chart 4: H1 annualized equity inflows greater than prior 20 years

Annualized equity flows in H1 vs cumulative historical (\$bn)



Source: BofA Global Investment Strategy, EPFR; note H1'21 is annualized

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The sheer quantum of money directed at equities when fixed interest yields nothing is no surprise; never in living memory have we seen the spigots of monetary and fiscal policy so open, at the same time.

³ Factset

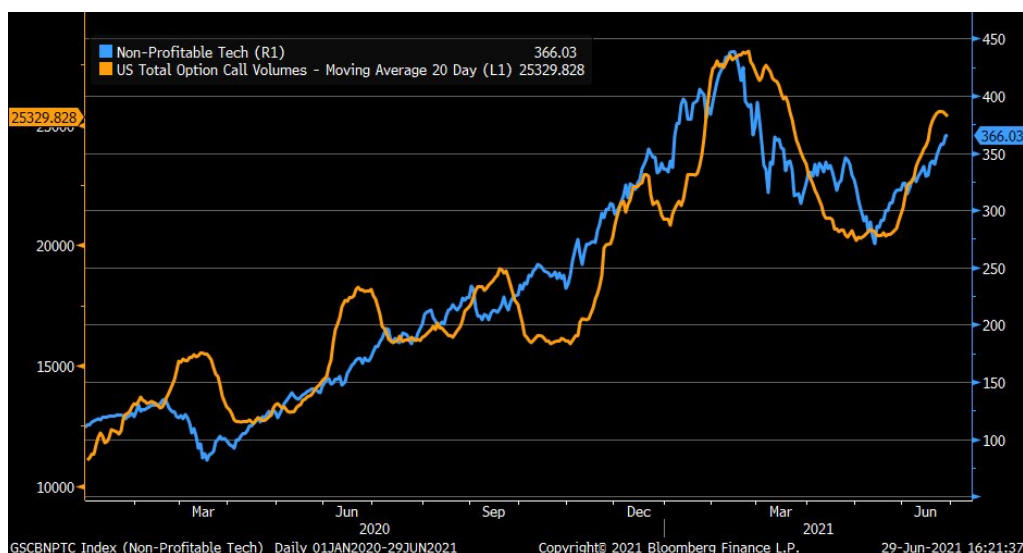
⁴ ibid

M2 money supply in the USA grew 24% during 2020 and is still rattling along at a 13% year over year rate at end May 2021⁵. US total public debt as a percentage of GDP recently scaled a record high 135% - over four TIMES the level of 1980 and twice the level of 2008⁶.

Trying to understand Fed policy is now extremely difficult. The latest June unemployment figures in the US show that the unemployed PLUS those “marginally attached to the labor force” now constitute 9.8% of the overall labour force; the recent low in December 2019 was 6.8% and the last time we were at these figures (on the way down) was May 2016. In May 2016, the 2 year bond yield was 0.9% against the current 0.26%; 10 year Treasury yields were around 1.8% - roughly where they got to at worst this year, and 35bp above where they are now.

Don't forget, as employment recovered further, 10year yields rose to over 3% in November 2018. The manner in which markets respond to minute changes in yields, shown in the past quarter (both ways) is most concerning, and suggests the Federal Reserve Board, and most other central banks, are trapped at these low rates and requisite bond purchases. Federal debt held by Federal Reserve banks⁷ now equates to over 24% of US GDP; in 2008, at the depths of recession, it was just over 3%. These simple figures show we truly are in the craziest, Frankenstein monetary experiment ever. No-one alive has ever seen this. However, there is an increasing sense and foreboding that it is coming to a conclusion, when the consequences seem frightening.

When money is so freely available – and free – past history suggests it leads to permissive behaviour. This is manifested in different ways. Record numbers of IPOs, belief that the majority of “new technology” will automatically yield very high long term excess returns, junk bonds that will not default (spreads versus Treasuries now at 3% akin to mid-2007), that you can just buy assets at any prices to “set and forget” (notably housing, selected blue chip stocks⁸) or that anyone can make short term returns out of equities from trading and playing – as the access to stockmarkets, or their derivatives is easier than ever via Robinhood and commission free trading.



⁵ Federal Reserve Board of St. Louis “FRED” data

⁶ ibid

⁷ ibid

⁸ If ever you are going to read John Brookes “the Go-Go Years”, please do it now

Retail investor interest in markets - particularly via options as shown in the chart above – reached absurd levels in Q1CY21; after fading, it continued again from mid-May 2021, suggesting the recent rally in tech stocks and growth equities to have less than solid foundations. Recent indications (put/call options ratios, for example) suggest it may again be rolling over.

Speculating in call options - the right but not obligation to buy a security within a defined timeframe in the future at a fixed price – was a key feature of the “meme” stock movement (GameStop, AMC Entertainment etc⁹) and correlates very highly with the performance of technology companies which are NOT profitable. These are the types of companies which may have a business plan – usually flawed – which they have to continually sell to investors to raise new capital. These are the type of stocks which cratered 80%+ in the “tech wreck” of 2000-2003.

We also note that US index performance has been becoming thinner, with the wider market starting to underperform the larger indices such as S&P500 and NASDAQ 100 (22% and 41% FAAMG¹⁰ respectively).

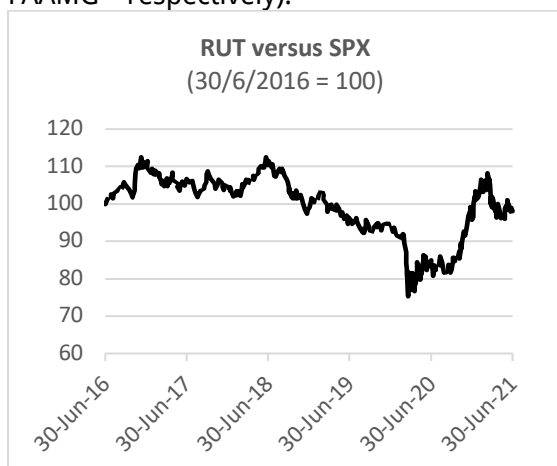


Chart 19: GWIM equity allocation at record 64.8%
BofA private client equity holdings as % of AUM



Source: BofA Global Investment Strategy

The Russell 2000 (RUT) is a highly diverse index comprised of that number of smaller companies; the largest weighting of an individual company is currently 0.72% (the meme stock AMC Entertainment) with an average market value of \$1.85billion (median \$1.15billion).

East 72 has increasingly used RUT as a hedging mechanism in tandem with S&P500, since we don’t end up (unwittingly) shorting large scale technology companies in volume. RUT outperformed the S&P500 by over 40% from the market bottom in March 2020; recent indications suggest such performance is starting to rollover. We are circumspect in our use of RUT given its much greater daily volatility compared to S&P500.

The Bank of America Global Investment Strategy survey suggest private client investors are “all-in” to equities, which would line up with some of the traits observed above; of course, this is a rather useful contrarian indicator (over time) suggesting these folks historically buy high, sell low.

So where might the problems emerge now everyone is as long equities as they have ever been?

⁹ The Bendon/Naked Brands article “How a Reddit army brought an Aussie lingerie icon back from the dead” (AFR 2 July 2021) is a brilliant read in this area.

¹⁰ Facebook, Apple, Amazon, Microsoft, Alphabet (Google)

The past six weeks has once again reinforced the interest rate sensitivity within equity markets. With a clear belief amongst many that low rates – at both the short and longer end of the interest rate curve – are here to stay, what might change that and create greater issues? The obvious answer is unforeseen inflation or a belief that inflation currently perceived as transitory becomes more permanent.

There are obvious pockets of “demand pull” inflation, with increased demand coming out of a pandemic where supply is restricted. This can be seen in vehicle prices, which for new cars are up 15% in the USA in June over the corresponding 2020 month. The inflation rate for cars is likely to subside once supply comes back on stream, which in turn is related to increasing the level of semi-conductor production in Taiwan – as their drought and COVID cases subside. (so whoever thought that the price of your used car was going to be a function of Taipei’s weather?)

The biggest area of demand pull inflation, which is yet to show up in the CPI numbers for the US (or Australia) is housing. This is partly a function of changed collection methods due to COVID and the use of “imputed rent” in the US statistics which capture asset price inflation within the housing market – but with a lag. In total, housing accounts for 32% of US CPI figures.

The other side of inflation is “cost push” where a third party influence on inputs impacts the cost of a good. The clear one at present is freight rates which have risen dramatically, particularly on the China-West Coast US route. The cost of shifting the average FEU¹¹ has risen from just under US\$1,800 to \$6,300 from end June 2020 to now. Moving the same container from China to Northern Europe has doubled to over \$11,350 over the past twelve months. That, of course, assumes you can GET a container. The combination of vessels out of service for ISO 2020 refits, port blockages from undermanning due to COVID and profit maximisation as demand skyrockets is fuelling these amazing moves. There are small signs at both the China and Los Angeles ends that ports are freeing up a little. But these moves are still to feed through to the consumer.

The biggest aspect to fuelling inflation is **expectations**. As we know from the 1970’s and 1980’s, once inflation expectations rise, getting this genie back in the bottle is very difficult. Why? Because people start to build it into their daily lives, and begin to combat the problem: putting up prices at their outlets ahead of time, demanding higher wage rises (at a time of seeming labour shortages). Folks are very sensitive to higher fuel prices, which (of course) economists try to detract from the CPI figures: they are transparent and easily observable.

If inflation expectations break out, we know in the Australian context how difficult it is to quell them. Our last major bout of inflation subsided in the mid-late 1990’s after the Hawke/Keating/ACTU “Accord”, an eventuality unlikely to be repeatable. In the US, it took Volker’s sky-high interest rates and a recession to do so. The current economic situation has increasing challenged the narrative that ‘deflation’ is an ongoing phenomenon, given that oligopolies around the world appear to dominate selected industries ranging from “streaming” to iron ore to specialist computer chips to search. Service industries, with their key inputs of “people” are not immune.

With long bond rates below 1.5%, credit spreads close to very cyclical historic lows, in this type of world, with numerous aggressive cost-push influences, the chance of bond market dislocation from here appears more likely, especially after investors have now moved away from their extreme bearishness of only a few weeks ago.

¹¹ Forty-foot equivalent unit container



Portfolio structure

Our top ten long positions in alphabetical order as at 30 June 2021 are:

(The) Agency Group	Macerich
BNK Bank	Namoi Cotton Limited
Deterra Royalties	Prime Media Limited
E-L Financial Corp	Treasure ASA
HAL Trust	Yellow Brick Road Limited

The main changes over the quarter were:

- Acquisition of new positions in Agency Group, an Australian real estate agency group (driven by volumes, not price) and BNK Bank, a mortgage aggregator and bank; both securities have been through difficult periods but have reorganised their share registers and look significantly underpriced and should benefit from mild upward moves in interest rates;
- Sale of our stake in Valhi which at one stage rose 56% over its end March 2021 level; we realised a 96% gain over purchase price in November 2020;
- Reduction of our stake in Australian Rural Capital at a price roughly twice net asset backing, adjusted for the recent rights issue;
- Acquisition of a smaller position in BOWX Acquisition Corp (BOWX), the SPAC which is acquiring WeWork. At prevailing prices of BOWX, the enterprise value of WeWork is ~US\$10.2billion – an 80% discount to the mooted (and aborted) IPO price in 2019. We view WeWork as having real traction as a business in the post COVID world, which has now arrived in its major markets;
- we acquired three stocks on price weakness which all performed exceptionally after our purchase:
 - Appen (the Australian AI and machine learning company) purchased on a free cash flow yield of 6%, and which rose 20% thereafter;
 - Macerich, with an equity capitalisation of only US\$3.8billion, one of the largest shopping centre owners in the USA, and is seeing significant improvements in patronage and space rentals; the shares are up around 44% from our \$12.70/share acquisition price,
 - Spotify, the streaming audio business, which is now exhibiting pricing power and a wider array of product via podcasting, has risen some 24% over our purchase price.

Future comments

In the type of evolving environment we have mapped out, and with short sale positions across the S&P500 at very low levels, we believe the complacency and permissiveness within markets suggests that a long/short strategy will pay dividends over the next 12-18months.

Our gross return of 33.6% in fiscal 2021 was achieved despite being an average of 22.5% net-long invested at month ends through the period. We are currently 67% net invested (182% long, 80% index hedged; 35% high beta short stock positions) so can reduce much further.

This suggests when some of the mania in unprofitable business models subsides, we should benefit, as well as if some of our longer held highly undervalued positions come to fruition. In addition, our cost base in FY22 will be lower than FY21. The two contrasting stock examples below, we hope, illustrate these phenomena.

Namoi Cotton Limited: five frustrating years on, we're finally at the starting gate

On 26 July 2016 – so nearly five years ago – we bought our first shares in Namoi at 36c - roughly the same price they are today. We have one dividend of 1.9c in July 2018. The investment thesis we had then still remains; however, its execution has been painfully, painfully slow. Increasingly we feel that in the past few months, a culmination of management and board actions, together with ongoing help from the weather, hold out hope for much better future returns.

Namoi is Australia's only listed cotton ginner, with a capacity of 1.5million bales¹² from nine wholly owned and two joint venture gins; two of the wholly owned are in the McIntyre Valley in Queensland, the remainder spread across four valleys in NSW. A cotton ginner separates the cotton lint from cotton seed, with each being sold to either a third party or repurchased. This lends itself to a series of adjacent activities such as cotton marketing, warehousing, packing, trading and processing. As a general comment, it is these activities which historically have under delivered for Namoi and in 2011, nearly bankrupted the entity.

Namoi was established in 1962 as a co-operative, and has been an unfortunate exercise – not uniquely – in co-operatives mixing with publicly issued permanent capital to provide an example of how the two just don't seem to blend. The members of the co-operative usually want a rebate or some other form of benefit, which reduces returns to the public shareholders. Few have been able to find the right balance, including Namoi. The situation usually turns into a slanging match between the two groups.

In February 1998, Namoi offered 44.4million new capital stock units ("shares") to the public at \$0.80 to supplement the existing 56.7million units held by growers; individual growers also held a maximum of 800 Grower Notes – redeemable at \$2.70 – which cemented control of the entity given the assorted voting restrictions on the shares.

Dividends were lifted sharply from FY2006; Namoi has a February balance date which means, for example, that the February 2006 results reflected the calendar 2005 cotton crop. The entity also embarked on a share buy back plan. This shareholder generosity coincided not only with an uptick in ginning volumes and significant improvement in ginning profits, but a merger approach from the then other ASX-listed ginner, Queensland Cotton Holdings (QCH).

The manner in which QCH galvanised the board to fight off the takeover in July 2005 has barely been repeated until the past two years; the QCH offer to shareholders - \$0.71per share (\$81million) and extraordinarily generous offer to Grower Note holders equating to \$83.93/Note against their redemption value of \$2.70 (a \$28million seduction) was emphatically rejected. Having finally seen off QCH in January 2006, Namoi then embarked on a share buy-back spree for the next year, paying prices in the mid-60c area, a mere 50% premium to the level two years prior.

¹² A bale is 500lbs or 226.8kg. At the prevailing price of cotton on CME of US\$0.84/lb and fx of 0.7550 a bale is notionally worth A\$556.

Having been treated like pariahs, Namoi shareholders generally lost interest and in line with reduced ginning profits in the FY09-FY11 period, perking up slightly in the early part of calendar 2011, as the cotton price started to improve along with expected ginning volumes.

Namoi's 1998 prospectus¹³ is very clear as to the various risks impacting on the company, the majority of which, at the time revolved around the marketing business, which sat 100% owned alongside the ginning operations. Apart from credit risk and basis risk (difference between Namoi cotton quality and CME cotton futures standards), Namoi sold cotton futures forward to lock in prices payable to their farmer/suppliers. This requires some degree of risk management, but on the fateful day of 4 October 2011, it became clear that with the cotton price having traversed US\$2.00/lb and back to US\$1.00 (its currently about US\$84c) that the cost of rolling hedges had swamped the company, and produced losses of over \$50million. Namoi shares collapsed to a low of 8c the following day, and an urgent recapitalisation was finalised in early 2013 after an eventual \$100million pre-tax loss in FY2012.

This recapitalisation, involving Louis Dreyfus Commodities establishing a marketing JV (Namoi Cotton Alliance) and accepting a placement, finalised in April 2013, paved the way for Namoi to modernise. Unfortunately, it has been a painstakingly slow process. The incumbent board lobbied against an outside Director nomination in June 2013, but there was a gradual realisation that access to outside equity capital had been closed – with the shares trading at one-quarter of net asset value. Hence, the company was ostensibly beholden to their bankers, despite improving conditions, paving the way for a corporate reconstruction in 2017 to remove the Grower Notes, and a rolling reconstruction of the board (mainly in June 2018), and eventual removal of all senior management in 2019.

Of course, these changes did not manifest themselves in an uplift in the share price, since they coincided with the worst drought in over 100years in many of the major areas of company operations!

FY Feb	season	bales ginned	GINNING EBITDA	central overhead	capex
2009	2008	178,000	4,040	5,076	3,949
2010	2009	398,000	4,388	5,618	6,942
2011	2010	516,000	5,862	5,604	6,250
2012	2011	1,058,000	18,624	6,070	4,776
2013	2012	1,292,000	30,373	6,724	6,073
2014	2013	1,244,000	26,205	7,357	3,007
2015	2014	1,123,000	25,591	7,265	10,315
2016	2015	535,000	8,976	6,099	5,675
2017	2016	689,000	13,738	6,579	4,446
2018	2017	1,015,000	27,005	9,108	7,152
2019	2018	1,202,000	29,759	8,810	7,611
2020	2019	450,000	6,780	8,932	1,123
2021	2020	124,000	(806)	6,794	170
AVERAGE		755,692	15,426	6,926	5,191

Without being libellous, it is difficult to convey our sense of annoyance with past management and board preceding the changes of mid-2018 which brought three board members. Why?

Looking at the two “bumper” years of 2017 and 2018, out of over \$56million of EBITDA from ginning, shareholders received only \$2.6million in dividends. The rest went on excessive capital expenditure and significant increases in central overhead.

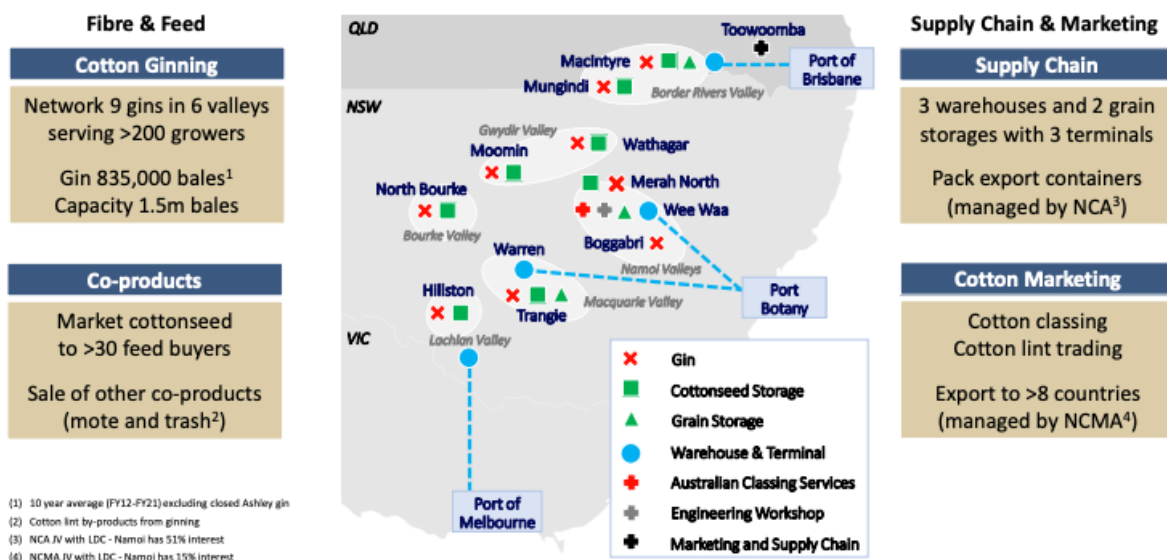
In addition, there was significant underperformance in the marketing business (ostensibly controlled by Louis Dreyfus Commodities) plus a 15% minority position in an oilseeds JV controlled by Cargill¹⁴ which we are aware effectively blew up its equity.

Namoi have exited the oilseeds JV and restructured the relationship with Dreyfus to get away from the main balance sheet issues – trading – by limiting their interest in that to 15%, but retaining the 51% interest in the (unencumbered) warehousing and packing component.

What we now have in Namoi is an expected four- pronged uplift in the company's fortunes from:

- breaking of the drought with expected increase in ginning volumes;
- removal of the main risks from marketing and cotton seeds leaving the key focus on the area of competitive advantage: ginning
- significant reductions in overhead costs from a focused management and board; and
- improved balance sheet parameters via a recent placement of shares at \$0.34

Network of 4 integrated businesses operating along the cotton value chain from the grower to spinner



In the 2021 season (reported in February 2022), Namoi will record a lower than usual market share (450k bales of 2.5million = 18%) simply because of the differing water availability across its valleys; at the current stage, this is expected to reverse in 2022 (reported in February 2023) where the company expect a doubling of cotton production in the Company's catchment valleys, set against an increase in national cotton production to just over 4million bales. This suggests Namoi could gin ~ 900k to 1m bales in 2022

¹⁴ Auscott (J W Boswell at the time) also owned 15%



		FY21	FY22 Forecast	
Cotton Production¹		0.6m bales	2.5m bales	4.2x
Namoi Cotton Volumes	Ginned cotton	124,000 bales	450,000 bales	3.6x
	Cottonseed marketed	34,000 tonnes	110,000 tonnes	3.1x
	Warehoused bales³	131,000 bales	500,000 bales	3.7x
	Grain packed⁴	100,000 tonnes	200,000 tonnes	2.0x

Based on past ginning earnings at these volumes, and applying known cost reductions at the operational and overhead level, would suggest the company could earn EBITDA of ~\$22million in FY23 (the year to February 2023).

At current prices of \$0.37, with a market capitalisation of \$64million and reduced net debt of ~\$40million, this leaves the company on an EV/EBITDA multiple of well below 5x our estimated FY23 earnings.

Three other aspects underpin our thinking. Firstly, NTA/share is approximately 68c after the recent capital raisings, meaning they were done at half NTA. In our view, when Namoi's capacity is assessed against the build costs of gins measured on a per bale basis, the carrying value of the gins at \$123million (\$82/bale of capacity) compares very well with parameters such as the Rivcott gin built in Carrathool in the Riverina in 2005 for \$24million (150k bale capacity).

Secondly, the final aspect of converting Namoi to a fully-fledged public entity should take place on 20th July, when the AGM will seek to ratify the continuation of shareholder limits of 20% in the Company. It won't, given the new composition of the share register, and a most-welcome Director's recommendation not to renew the limits.

Finally, Directors have made clear their intention to pay dividends in average (835k bales) and above seasons, subject to obvious caveats.

Hence, we now have a shareholder friendly board who have driven significant cost reductions through a drought, had to raise expensive capital, but now have a clear vision as to the enhancement of shareholder return. We hopefully won't have to wait a further five years for some joy.

Sezzle: ask no questions, get told no lies - banking the unbankable?

In our opinion, Sezzle (ASX:SZL) is one of the worst type of companies which thrive in permissive markets such as those created by extreme monetary policy, risk taking and "story-telling" around simple technology. Sezzle is a ~ A\$2billion priced Minnesota based BNPL company, listed in Australia, but with no operations here. There is minimal analysis, in our opinion, by Australians with a long position in the shares, or understanding of really what might be happening. This sits alongside an unwillingness by the company to shed any light on the most unusual financing structure within the BNPL sector, and the reasons why.

Sezzle's recent Form 10 (**Form10**) lodgement with US SEC and ASX¹⁵ is a gold mine of information showing the pressure the business is under from loss making BNPL lending, alliances with larger merchants on onerous terms, and egregious funding relationships. **The company highlights absolutely none of these factors in its upbeat, effusive presentations.**

By working with the financials in the Form10 added to other information, we can start to draw strong inferences regarding Sezzle's underlying business model, the nature of many of its merchants and the possibility it is partly operating a bank for the unbankable.

With the assistance of others¹⁶ interested in the potential barbequing of investors' money for the benefit of a small number of executives with securities in the company acquired at minimal cost (but valued in the hundreds of millions) we have compiled the following abridged thesis, which is part of the rationale behind our short-sale position in the shares.

There are **seven** key components to our short sale thesis for Sezzle, as follows:

1. *Capital structure: the anti-"Outsiders"¹⁷*

In our opinion, investors in SZL have been extremely kind in allowing massive vendor uplifts to insiders in exchange for what would be mandatory escrow provisions; the early days of SZL's operations shows a management team prepared to throw shares around like confetti – as long as it is to themselves and friends at advantageous prices.

The SZL Prospectus¹⁸ transparently shows that in exchange for the management team and its backers doing two year's work – the company being incorporated in August 2017 – they were happy to sell that effort and its US\$6.5million of losses – to Australian investors for **a mere \$142million uplift at the IPO price** of A\$1.22 per CDI (**SZL Share**). The company pre-IPO had 130million shares on issue for which investors – mainly Charlie Yoakhim the executive Chair and his coterie, had paid a mere US\$11.78million.

In addition, SZL executives thought so highly of the value of their SZL Shares, they were prepared to offer a total of US\$5.813million of convertible notes which converted to shares at the end of July 2019 at US\$0.49/share (A\$0.70) or a 122% uplift at the IPO price for less than four months holding period.

At the prevailing share price of A\$9.00 per SZL Share, these uplifts now equate to A\$1.15billion and \$98.5million – **around A\$1.25billion for questionable effort.**

After an institutional placement in July 2020 of 14.9million SZL Shares at \$5.30, SZL is left with a capital structure which is still highly disadvantageous to investors, unless it can get away its US IPO – with some escrow sales – at a good price. In our view, markets are so crazy in this sector/space at present, it will do. But what comes afterwards?

¹⁵ ASX Market Announcements Platform 11 June 2021

¹⁶ A number of our twitter friends ("FinTwit") have provided assistance with background for this piece adding significantly to our own research. Most are anonymous or have a "nom-de-plume" handle; they know who they are and we acknowledge their efforts.

¹⁷ "Outsiders" is the magnificent book by William Thorndike detailing eight CEO's who all are active managers of capital and all of who have used share buy backs to great effect.

¹⁸ Replacement prospectus dated 8 July 2019

The current capital structure of 225.7million fully diluted SZL Shares is:

- 103.5million SZL Shares;
- 94.0 escrowed SZL Shares emerging on 29 July 2021;
- 25.3 million SZL options and convertibles many of which have exercise prices as low as 5c established pre the IPO with eight years left to run; and
- 2.8million assorted other shares

In other words, some 54% of the diluted equity base is “locked-up” – a very high proportion.

2. *Management presentations are aggressive and omit material negative issues*

There are a myriad of examples of this phenomenon, including the Merchant Interest Program (**MIP**) discussed later, but the two most topical and recent are:

- (a) on 11th June 2021, SZL held their AGM on the same day as lodging an amended Form 10 to the US SEC for registration of securities. The AGM presentation contained only revenue and customer related metrics and a bunch of feel good statements about “opportunities to shape the future” and “doing good for the good of all”. Notably on slide 25, headed “Momentum continued in Q121, there are the usual upward sloping bars.

The momentum certainly continued in Q1 21 – but of staggering losses. Page 50 of the Form10 filing of 11 June 2021 shows SZL lost a further US\$10.2million pre-tax in the quarter to March 2021, before paying away a US\$1.1million fee for early termination of a line of credit they were struggling to use. This compares to quarterly losses of US\$4.4million in Q1CY20 and US\$3.8mn in Q2CY20 plus an average of US\$12.1million in Q3/Q4CY20. There is no mention whatsoever of pre-tax losses in the 33 page AGM presentation.

- (b) Far more insidious - if you are happy to gloss over such losses – are the series of announcements reflecting the changed business model to focus on larger scale merchants. Since late April 2021, SZL have announced three merchant partnerships - Market America Worldwide (29 April), Lamps Plus Partnership (26 May) and a three year agreement with Target Corporation (3 June) along with a longer term finance offer with Ally (20 May).

However, in none of these releases to ASX – on the relevant dates noted above - is it disclosed that:

- SZL is committed to reimbursing up to approximately US\$35million to these merchants in co-marketing expenses¹⁹; and
- in the event of SZL not meeting certain volume criteria and implementation benchmarks with certain merchants, SZL may be required to make further payments²⁰.

¹⁹ Page F-36 of Form 10 under Subsequent Events

²⁰ ibid

It's worth noting that as at 31 March 2021, SZL had only US\$41.6million of unrestricted cash, \$US\$8.0million of accrued liabilities and is burning through US\$5-6million a quarter in cash operating losses, once the the benefit of share based payments is added back. It's not unreasonable to conclude that SZL probably NEEDS an equity issue of some description.

Moreover, in page F-35 of the Form10, SZL disclosed it is already under pressure from an agreement signed in December 2020 that it was probable it would not meet its first contractual performance obligation under the agreement to 30 June 2021, and would be required to make an "expense". We don't know exactly, but believe this relationship is Game Stop – SZL's largest referrer (see later) – suggesting where they are in a non-exclusive relationship, SZL are being aggressively outcompeted by other BNPL providers. Big announcements, questionable execution.

3. *Sezzle is underperforming versus identifiable competitors such as QuadPay*

In June 2020, ZipPay (ASX:Z1P) announced the acquisition of a US BNPL entity, QuadPay, for A\$403million, mainly using Z1P scrip to vendors and via a placement; let's compare the metrics of the two businesses, together with that of Afterpay, since that point, to 31 March 2021 in North America (Klarna don't give the transparency of statistics in the US):

Before looking at the table, it is worth noting that at the time of Z1P buying Quadpay, SZL had a market capitalisation of A\$572million (share price:\$2.60) and that Z1P issued shares to buy Quadpay at \$3.39:

	Afterpay	Sezzle (A\$1=US\$0.75)	ZipPay (QuadPay)
NA Customers: 30/6/20	5.6million	1.475million	1.8million
NA Customers: 31/3/21	9.3million	2.6million	3.8million
Growth:	3.7million	1.125million	2.0million
NA Merchants: 30/6/20	11,500	16,100	3,500
NA Merchants: 31/3/21	23,200	34,000	13,000
R12 NA sales	A\$8.4billion	A\$1.483billion	1.968billion
R12 marketing expense (global)	A\$108million	A\$5.8million	A\$30million

Since that time, SZL shares have appreciated by 246% to \$9.00 (+\$1.4billion to market value), vastly outperforming Z1P shares (+124% to \$7.60) despite the clearly better growth of Z1P.

It is rather clear, even from the above simplified table, that:

- SZL does not have the marketing clout to compete with APT, Quadpay (or Klarna) – it does not have access to the sheer scale of equity capital to support an aggressive and expensive marketing strategy. In the six months to December 2020, globally, each new Afterpay customer costs around A\$21.60 to acquire; Z1P is lower at A\$14.47. For Sezzle, it's about A\$5.30 equivalent. In our opinion, that is not a positive – it's a negative.

- Sezzle's underlying sales per merchant are very low reflecting the fact they have far fewer tie ups with large scale merchants – the quality of Sezzle's merchants is discussed further in 6 and 7 below.

In our opinion, Sezzle has limited competitive traction against the visible larger players, let alone others such as Paypal. The unsustainability of the business model becomes clearer when we look at the fees charged to these smaller merchants, which then morphs into questioning the nature of such customers.

4. *Sezzle continues to lend to high risk customers....*

Sezzle has a worrying track record of lending to customers who are unable to repay their lending commitments from the company. Somewhat surprisingly, in a new industry where initial loss expectations will be high, but where participants should learn from early mistakes, we see limited signs of these benefits within SZL.

As an example, within Afterpay, impairments as a proportion of underlying sales have averaged 92bp since the end of CY15, and have shown a gradual downward trajectory from 165bp in the half to December 2016 down to the latest two half years being around 0.74%.

Since Sezzle commenced in 2017 through 31 March 2021, the company's **cumulative** underlying sales have totalled just over US\$1.5billion; the Company has racked up total write-offs of US\$23.8million and had US\$11.6million of provisions, to total cumulative credit losses of US\$35.4million – 2.35% of underlying sales. This is over two and a half times the relevant ratio at Afterpay, and illustrated below, is not an improving trend:

US\$000's	starting provision	raised provision	writeoffs	period end provision	gross loans	cum write offs	Cum w/o+ remaining provision	UMS period	Cum UMS	P&L period charge/UMS	cumulative
FY 17	-	46	-	46	265	-	46	822	822	5.60%	5.60%
FY 18	46	940	341	645	5,720	341	986	31,083	31,905	2.95%	3.09%
H1 19	645	1,744	1,178	1,211	12,441	1,519	2,730	70,233	102,138	3.41%	2.67%
H2 19	1,211	4,492	2,241	3,462	29,701	3,760	7,222	173,867	276,005	3.26%	2.62%
H1 20	3,462	5,135	4,529	4,068	50,571	8,289	12,357	307,400	583,405	1.76%	2.12%
H2 20	4,068	14,453	7,388	11,133	95,399	15,677	26,810	549,000	1,132,405	2.55%	2.37%
Q1 21	11,133	8,577	8,078	11,632	113,623	23,755	35,387	375,100	1,507,505	2.28%	2.35%

Once again, Sezzle's selective disclosure in presentations doesn't extend to explaining that delinquencies in the first three months of CY21 continued close to the high levels of H2 CY20 and annualise at close to US\$35million per annum – around half of gross margin!!.

5. *...and so they charge very high fees but still make no money*

In less than four years to 31 March 2021, Sezzle has racked up pre-tax losses of US\$60million (excluding extraordinary items) of which nearly 60% relate to credit losses, noted above. Unlike many other high growth companies at this stage of development, these losses are **not** due to hefty sales and marketing expenses – in total since incorporation, Sezzle has only expended US\$7m or so in marketing. As we discussed in section (2) above, that's about to change – significantly.

Moreover, these pre-tax losses have accrued despite merchant charges which are well above the cohort group. Indeed, bizarrely in an industry with increasing competition, SZL's merchant fees as a percentage of sales are actually increasing; in the latest quarter to 31 March 2021, merchant fees amounted to 5.93% of sales (see table next page); as a guide, Afterpay's fees/sales (excluding late fees paid by customers) equated to 3.89% having gently glided down from a peak of 5.44% in the half year to 31 December 2017, and averaged 4.10% over the past four and a half years.

Despite this, SZL's pre-tax losses have compounded dramatically over the past three quarters. In H2CY20, the Company lost a whopping US\$24.2million, and continued this ugly trend in Q1 CY21 with a pre-tax loss of \$US\$10.2million prior to the US\$1.1million cost of extinguishing the tripartite line of credit facility to transition to Goldman Sachs/Bastion.

SEZZLE INC: quarterly merchant fees								
US\$000's	Fees	Sales	Fees % of sales		US\$000's	Fees	Sales	Fees % of sales
Dec-17	26	822	3.11%		Sep-19	3,600	68,800	5.23%
Mar-18	77	1,584	4.89%		Dec-19	5,800	105,100	5.52%
Jun-18	155	2,940	5.27%		Mar-20	6,800	119,400	5.89%
Sep-18	393	8,086	4.86%		Jun-20	10,600	188,000	5.64%
Dec-18	857	18,471	4.64%		Sep-20	13,100	228,200	5.74%
Mar-19	1,427	28,326	5.04%		Dec-20	17,200	320,800	5.36%
Jun-19	2,129	41,907	5.08%		Mar-21	22,300	375,000	5.93%
TOTAL FROM INCEPTION						84,463	1,507,436	5.60%

It would appear that the more business that Sezzle transact, the more money they lose given the need to pay large co-marketing fees to counterparties, and the ongoing 2.25-2.5% of sales becoming uncollectible – effectively negating 40% of gross fees.

6. *Funding structure may strangle Sezzle without an equity issue*

SZL's funding structure, in particular the use of high interest alt-financiers on onerous terms, illustrates the company operates "on the fringe". When combined with its unique and undisclosed until July 2020 "Merchant Interest Program" (MIP) this is a funding structure with enormous risk.

The MIP is typical of SZL's haphazard public company reporting of crucial aspects of the Company's operation, and raises significant red flags. It first appeared in slide 15 of the capital raising presentation of July 2020²¹ with no explanation, despite being in place when the Company floated, but was not mentioned in the original July 2019 Prospectus. It has since been described in filings in a more fulsome manner commencing in August 2020²²

²¹ ASX Announcement "Capital Raising Presentation" 10 July 2020

²² ASX Announcement "2020 Half Year Report" 31 August 2020 Note 15, page 46

Aside from equity, there are two parts to the funding structure of SZL's receivables – lines of credit and the unique MIP whereby merchants who accept Sezzle can reinvest the purchase amount – minus the 5%+ fees – with SZL at LIBOR +3% (reduced from LIBOR +5% between June 2020 and December 2020). To the best of our knowledge, no other BNPL offers this “facility”. We will deal with why a merchant may wish to do this in the section 7 below; most smaller retailers we know, want to get the \$200 for their Nike sneakers very quickly, to replenish inventory..... but what if you're not selling Nike sneakers???



Since the IPO on 30 July 2019, SZL is now onto its third different lines of credit, all of which it has struggled to fully utilise. In November 2018, it had a \$30million line of credit with Bastion Funding, a high interest alt-financier based in Stamford (CT) who specialise in these lines of credit to fringe financiers (see picture to left):

Nothing wrong with that – but the initial loan rates to SZL were **LIBOR+12%** on the first \$15million and LIBOR +10% on the second \$15million.

In November 2019, the Bastion facility was refinanced into a \$100million facility with Bastion and two of its mates²³ at LIBOR +7.75% with minimum drawings of US\$20million from end-November 2019 and US\$40million from November 2020.

Under these arrangements, as is usual, the lenders required a level of restricted cash (US\$4.8million at 31 December 2020) and pledged receivables.

On 11 February 2021, in another masterstroke of selective disclosures²⁴, Sezzle trumpeted the entry of the Vampire Squid²⁵ as a partner alongside Bastion, leaving the two other financiers behind. The ASX announcement is disingenuous – the “covenants” include leaving US\$25million in restricted cash – FIVE TIMES the previous amount – for use of the facility which operates in two tranches of “A” (US\$97.2million at LIBOR + 3.375%) and “B” (US\$27.8million at LIBOR + 10.689%)

The facility requires pledging of pretty much the entire loan book – rightly – since it operates as a factoring type arrangement whereby SZL can draw down a maximum of 90%, depending on FICO score, of the pledged receivables. Now remember, these receivables have a delinquency rate of ~2.5% (flow) and ~10% (stock), so that's why the restricted cash is so high, for such a “loose” arrangement.

²³ Hudson Cove Credit Opportunity Master Fund and Atalaya Asset Income Fund

²⁴ “Sezzle signs \$250million receivables warehouse facility” ASX Release 11 February 2021, which talks of size, longevity and “other”, where other is described as covenants, representations and warrants and reporting obligations typical of a similar receivables Warehouse Facility”

²⁵ “The first thing you need to know about Goldman Sachs is that it's everywhere. The world's most powerful investment bank is a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money.” Matt Taibbi “The Great American Bubble Machine” (Rolling Stone 5 April 2010)

In our opinion, SZL's "Sezzle Up" campaign, whereby subject to conditions, SZL report your payment history to credit bureaux, is heavily related to this facility. FICO scores – the ubiquitous credit scoring system developed by Fair Isaac Corporation²⁶ (NYSE: FICO) – are usually in a range of 300 – 850; the cut-off with the Goldman facility to maintain factoring of 85% is 580 – the generally accepted FICO cut off where "fair" credit turns to "poor".

But these pledges of assets run into a roadblock – the MIP, whereby SZL allow the merchants to reinvest at LIBOR + 3%. What if there wasn't enough "cash" to repay the unsecured merchants when they want their money back (in maximum \$250k tranches)?

The 11 February 2021 announcement is so disingenuous, because it has led SZL down that potential pathway. The following table shows a massive adverse change after 31 December 2020, and that SZL are effectively US\$31million "short", by looking at the gap between:

- Assets pledged to the line of credit providers plus MIP (including normal creditors which are around 12-13% of MIP) – "liabilities"; and
- Total receivables plus **unrestricted** cash ("assets")

US\$000's	Pledged notes	MIP	TOTAL "liabilities"	Receivables	Unrestricted cash	TOTAL "assets"	"assets" – "liabilities"
31/12/2019	23,946	13,285	37,231	26,239	34,965	61,204	23,973
30/6/2020	42,018	39,178	81,196	46,504	52,779	99,283	18,087
31/12/2020	70,990	60,933	131,923	84,266	84,285	168,551	36,628
31/3/2021	97,747	76,579	174,326	101,991	41,606	143,597	(30,729)

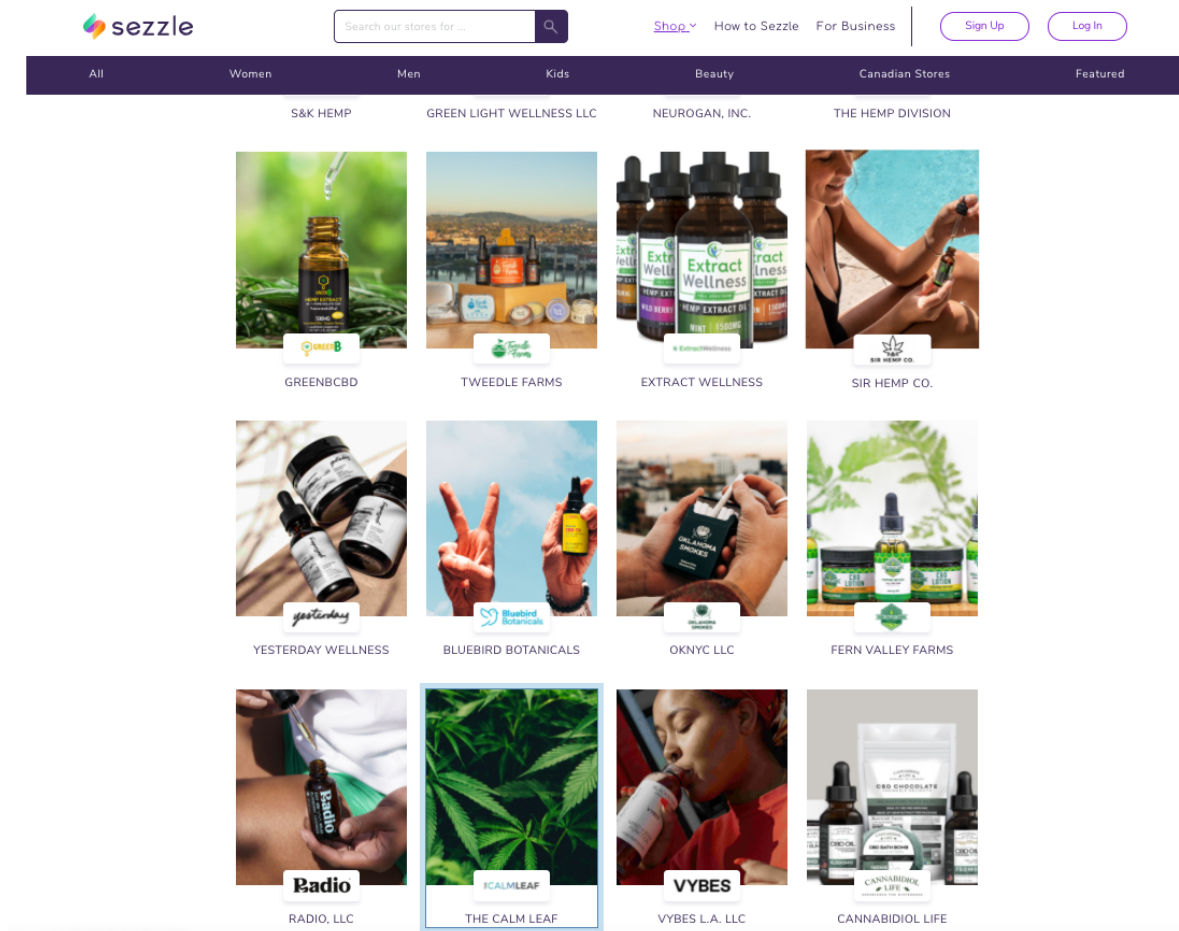
This is not terminal, but with the company losing ~US\$10million a quarter, it clearly makes sense to buttress their unrestricted cash with an equity raising. To do so as part of a US IPO, as key executives SZL Shares come out of escrow, makes even more sense. But would you want to be on the other side of the transaction, given you know it is a must do? How would you price it?

7. Who might these reinvesting merchants be?

You have money you "don't need straight away" and can get interest of LIBOR + 3% on it. So at the time of writing that's 3.13%. What's the catch? Well it's unsecured, the company you are "depositing" it with is losing around ~US\$40million a year, and virtually all of their receivables assets are pledged to two financiers who are way smarter than you. What if you **had** to keep your money in the MAP by necessity?

Traffic to Sezzle's website is around 75% direct and 25% referral. The direct travellers are able to look for categories from which to purchase. One of our cohort's research shows clearly that the SZL site is the only one to allow purchase of hemp products within the BNPL space (APT, Z1P, Klarna, Affirm do not). Put "hemp" into Sezzle's search bar:

²⁶ Fair Isaac (FICO) is one the GREAT US investments, being a near monopoly, the shares having bottomed at \$10 in February 2009 and now trading just over \$500.



“High risk” businesses – drug paraphernalia, “herbal flowers”, escort services, adult bookstores, on-line casinos, lottery stands - are not illegal in many jurisdictions. However, payment processors of credit/debit cards used by every retail outlet have an industry code – easily viewed on-line. Various industry codes are deemed “high risk” (look up 5968²⁷) and many processors don’t want to deal with them. Other processors actively seek out this type of business, often using non-Visa cards, as the margins are very high indeed.

We can gain more than an inkling that SZL’s business is far higher risk than its ASX-listed cohort, through analysis of its “cost of sales” - the simple cost of processing the payments to SZL before overhead costs. This has historically equated to over 3% of sales equivalent (c.f. Afterpay 1.12% to 1.25%), and despite increases in sales volumes (at significant overhead costs) is still TWICE that of Afterpay at 2.38% in the three months to 31 March 2021.

We boxed “The Calm Leaf” in the Sezzle screenshot (above); The Calm Leaf is a totally legal seller of hemp products based in Hollywood, CA. The screenshot below shows just one of their many products, and the legal restrictions around where they cannot be dispatched.

²⁷ “Direct marketing, continuity/subscription merchant for pornography websites, content memberships, and other adult continuity products, such as electronic items”

Farma Barn Delta 8 THC Flower Pre-Rolls

Farma Barn

★★★★★ 38 reviews

Shipping: This product can't be shipped to Alaska, Arizona, Arkansas, Colorado, Delaware, Idaho, Iowa, Mississippi, Montana, Rhode Island, Utah

\$14.99

Count *

1 5

Quantity:

 1

ADD TO CART

Add To Wish List








The problem in this industry comes because of US banking practices. A recent “Reuters” article²⁸ points out that whilst marijuana businesses are doing extremely well in the US, a result of decriminalisation in many states, the fact it is still illegal at a Federal level means that US banks will NOT bank the industry. As a consequence, these businesses are rolling in cash, making them obvious targets for bandits.

What if you could transact using a BNPL platform like Sezzle, and reinvest the money with the platform, until Federal legislation changed? Of course, when Federal legislation does change, what happens to Sezzle’s form of cheap funding? We’ll leave you to ponder whether Citibank or Sezzle might be a safer place for your cash deposit.

On the other side of the customer/merchant coin, around a quarter of traffic to Sezzle’s website is via referrals; the top referrer is GameStop. However, referrers 2,3 and 4 as in April 2021²⁹ were rightstufanime, crunchyroll (both anime³⁰ sellers) and lelo.com. Lelo?³¹ Show it to your partner, but not at work.

Since Sezzle will not disclose its underlying merchants sales by industry, we have no way of knowing what proportion of sales are comprised by these type of high risk merchants, some of which are unbankable. Moreover, if they become bankable, which eventually seems inevitable, the benefit of using Sezzle will be significantly diminished.

²⁸ “US pot sellers stash cash as banks leave them high and dry” (Shariq Khan, Reuters) 26 May 2021

²⁹ Courtesy of “ignore89039500” tweet 11 May 2021

³⁰ Japanese style cartoons both printed and video fantasies

³¹ Lelo.com is a Swedish “intimate products” retailer and has a superbly presented website – but definitely NSFW.



Further, Sezzle's need to make significant, barely affordable co-payments to larger merchants to get them to sign on (over US\$35million in future commitments), in an attempt to maintain the chimera of respectability adds, in our view, to the likely inevitable financial weakness of this enterprise.

In our opinion, "chimera" is a word that resonates through this corporation – an ongoing struggle between greed and respectability. Aside from the egregious insider interest, SZL is certified as a "B" Corporation³², and suggests its mission is to "financially empower the next generation". We find it hard to square that with charging merchants in high risk industries fees of up to 9%, having the highest merchant fees in the BNPL sector on a total basis, and engaging in the type of selective disclosures, omitting (and certainly glossing over) what we believe are material facts, as we have highlighted throughout this discussion.

Given its ongoing losses, which we believe will extend well into the future, we are astonished SZL has a market value of over A\$2billion. We expect a new issue of shares to the US market as part of the IPO, but also expect the two co-founders Charlie Youakim (88.4million SZL Shares) and Paul Paradis (10.0million SZL Shares) to avail themselves of the opportunity to "diversify their portfolio". In our view, so they should – but we won't be helping them.

For further information:

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³² A certification by BLab that the company meets verified standards of social, environmental, "business as a force for good" type companies. See ASX Release 30 March 2021 and [bcorporation.net](https://www.bcorporation.net)