Tapasya

Creating Generational Wealth

SEPTEMBER 16, 2023

TAPASYA INVESTMENT FUND I

GLOBAL INVESTMENT REVIEW - V

INTRODUCTION

Welcome to the **5th edition** of the "**Global Investment Review**". As mentioned in previous letters, the intent of this document is to detail the thesis of companies we have made investments in.

Given that we are a concentrated fund with investments in 14 companies thus far, I will provide my views on only one company moving forward. Keeping to the 2 companies each letter would be the last reason to add more companies to the portfolio.

What I would do to fill the blank pages is write about my investment philosophies so that each of you get a better understanding of how I think as it relates to investing. Another not so hidden agenda is to use you 'the reader' as guinea pigs as I work towards writing better copy.

While explaining our portfolio composition and sizing, I used the analogy of soccer to describe the portfolio broken up into Defense, Mid-Field and Offense.

As a quick refresher, **Defense** companies are expected to outperform the market during market downturns but at par or at times below par when the markets are in a euphoric state. **MidFielder** companies are expected to be steady compounders (not linear) that make up the bulk of our portfolio (>70%). **Offense** companies have potential for asymmetric returns but carry higher risk. These make up about 10%-15% of the portfolio inclusive of cash.

This letter, I will talk about one of our Offense companies - **Carvana**. This company was a tough one to write for me. I was planning to include it in my bi-annual letter as a '**mistake**'. I just liked the company a lot and was hesitant to accept it as a mistake. Mistake defined as current price lower than buy-price over a long period of time. My unwillingness to accept that mistake (hopefully that's not a trait I demonstrate too often) and some luck on my side, the company which had more than halved from my purchase price is now 2x+ of purchase price. Making this job a little easier, and easy I like.

The other topic included here is **DIVERSIFICATION.** This topic as important as it is, ruffles a lot of feathers. We have the likes of Warren Buffett and Charlie Munger, the later who I consider is the best teacher I have ever had talk about diversification as 'protection against ignorance'. At the same time you have all the business schools, financial advisors, experts like Ray Dalio talk about diversification and its importance.

What is right, what is wrong or is there a right or a wrong. My intent of writing on this topic is not to determine that, but more to give you a view of how I think about diversification. Are we diversified enough or not and how could this impact your money invested with me?

Happy Reading!!

CARVANA (CVNA)

Carvana operates an e-commerce platform for buying and selling used cars in the United States. Its platform allows customers to research and identify a vehicle; inspect it using the company's 360-degree vehicle imaging technology; obtain financing and warranty coverage; purchase the vehicle; and schedule delivery or pick-up from their desktop or mobile devices. The company was founded in 2012 and is based in Tempe, Arizona.

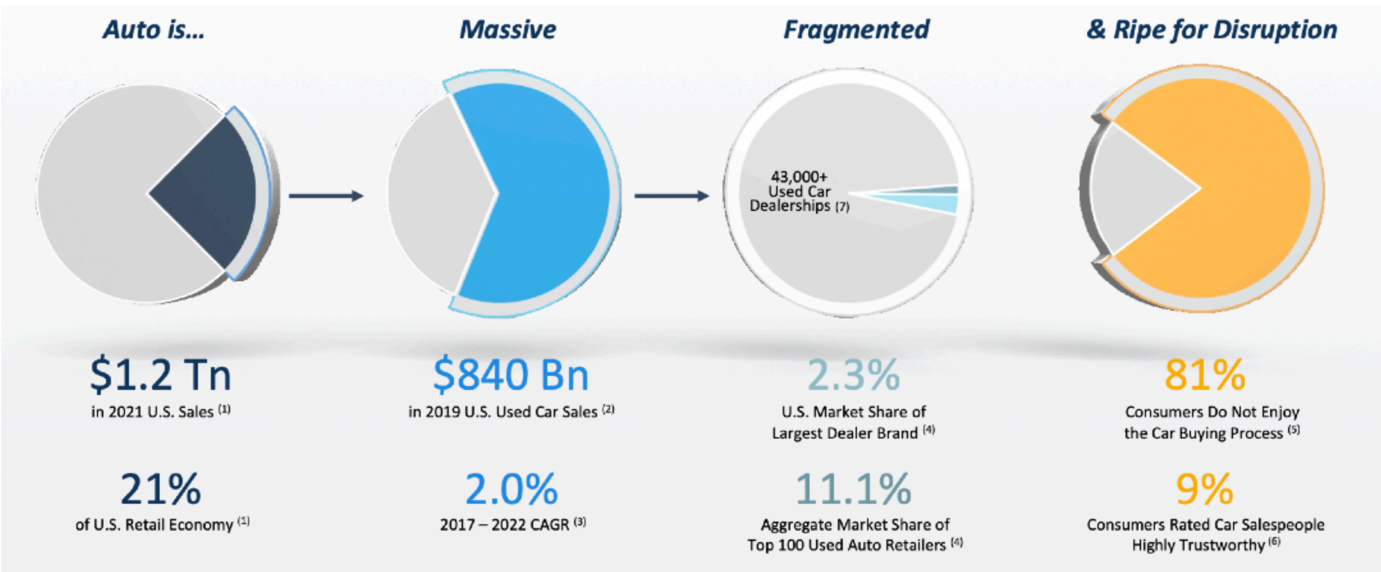
This has been a very controversial stock/company in the recent past. It has had a meteoric rise and then a fall that few companies have seen and survived. It had reached an all time high of $370 on Aug 10th 2021 and a low of $3.55 in 2023.

This is a company I like a lot, especially at the price we bought it. We have since doubled our money though that has not come easy. I have had to undergo the pain of holding it at over 80% of paper losses with the media suggesting it could go bankrupt and they could very well have been right. Then why do I hold this stock?

Is it even worth having in the portfolio with this extreme degree of volatility. As you may have seen me repeat many times now, volatility does not scare me at all. It is painful, but I have trained myself now for many years to be able to manage it well.

The reason I hold Carvana, is the potential the company has got to disrupt what is a very fragmented industry of buying/selling used cars, mired with bad customer experience. I for one have never enjoyed haggling with the car salesmen who push extremely hard to make a sale.

Let us understand the industry



The used car market is highly fragmented with the largest dealer having a 2.3% marketshare. 81% of the consumers do not enjoy the process. The market is very large at about $840Bn growing at a 2% CAGR.

Given the size of the market and it being as fragmented, gives any disruptor to make some significant inroads into this business. The question is whether Carvana can do that **profitably.**

Carvana has been growing its marketshare owing to the strong sales growth. With revenues growing from a mere $365M in 2016 to $12Bn in the last twelve months (LTM), such growth is generally unheard of in business. Sure a significant chunk was aided by the pandemic, low interest rates and money distributed during the pandemic. That said, even before pandemic their revenues grew 10x from $365M in 2016 to $3.9Bn in 2019.

Within a fragmented market the key is to continue to grow, looking at the top 5 markets which are Phoenix AZ, Columbus OH, Atlanta GA, Austin TX and Nashville TN; all these markets have shown impressive growth rates at marketshare of over 3%. This suggests that there is room to grow within existing markets while expanding into new markets in the US. My assumption is that CVNA could be about 6%-8% of the used car market which would mean revenues of approx. $48Bn-$64Bn.

From the current 12Bn run rate there seems to be significant room to grow.

Income Statement | TIKR.com	12/31/16	12/31/17	12/31/18	12/31/19	12/31/20	12/31/21	12/31/22	LTM
Revenues	365.15	858.87	1,955.47	3,940.00	5,587.00	12,814.00	13,604.00	11,797.00
Total Revenues	**365.15**	**858.87**	**1,955.47**	**3,940.00**	**5,587.00**	**12,814.00**	**13,604.00**	**11,797.00**
% Change YoY	***180.0%***	***135.2%***	***127.7%***	***101.5%***	***41.8%***	***129.4%***	***6.2%***	
Cost of Goods Sold	(344.05)	(787.98)	(1,754.36)	(3,430.00)	(4,786.00)	(10,880.00)	(12,354.00)	(10,401.00)
Gross Profit	**21.10**	**70.89**	**201.11**	**510.00**	**801.00**	**1,934.00**	**1,250.00**	**1,396.00**
% Change YoY	***1,042.8%***	***236.0%***	***183.7%***	***153.6%***	***57.1%***	***141.4%***	***(35.4%)***	
% Gross Margins	***5.8%***	***8.3%***	***10.3%***	***12.9%***	***14.3%***	***15.1%***	***9.2%***	***11.8%***

The other important question to be answered is profitability. CVNA has made some significant changes to its SG&A profile. Marketing spend is now about 2% of Revenues vs. 5%-7% pre-pandemic. Generally marketing spend tends to be productive dollars if spent well, the management has indicated that it would not move down any further.

SG&A, has moved down from 20%+ to now about 15%. The long term target for this metric as guided by management is about 8%. This my assumption is a function of increased revenues over time vs. lowering costs from current levels outside of minor optimizations.

Given a lot of this is based on future guidance, management's execution capability is what needs to be gauged, basically its "say-do" ratio. How much of what they say they are able to execute. In general, outside of macro factors such as high interest rates , etc., which affects housing first followed by the car market, the management has done a good job. They have had a near death experience recently, but have been able to stave that off.

We have acquired our stake at CVNA at what I would consider as a cheap valuation. It was part of the portfolio I call 'Offense' hence it represented only a 2%+ at cost when we purchased it. Since the purchase, the stock has moved from -80% to +120%+ of purchase price.

We currently are sitting at 2x+ of our purchase price. I do expect this company to grow 4 times its size today in the next 6-8 years which is approx. 26% CAGR. We will continue to monitor it.

Risks

1) High Interest Rate

2) Strength of Balance Sheet (due to high debt)

3) There is a reason for the fragmented market

There are certainly risks for this business like for every business. Some of the very near terms ones are interest rate risks. The higher rates have certainly slowed down the used car market, with unit sales falling quite significantly across the industry. I expect this to be short term i.e. another year or so.

CVNA has over $8 Bn in debt. It recently went through debt restructuring, which included extending maturities and at lower interest rates. This for now has pushed out any immediate concerns of bankruptcy. Should the economic environment change very significantly to the negative, this story could change very quickly.

Lastly, though the market is very fragmented thus creating opportunities for consolidation, the question arises whether it’s the nature of the market where consumers prefer brick & mortar, negotiating with a car salesperson to make that deal instead of going online to make a purchase. Many studies show that about 86% of the consumers start their car buying research online and about 61% would be comfortable buying their cars online.

I think of CVNA to some extent almost like Amazon within Retail, where it would continue to grow revenues and eventually move big chunks to the bottomline.

Though I have bought with a long term horizon, it would be a company that I would watch very closely. Should the story change (not stock price volatility) OR it becomes a meme stock, I would not hesitate to sell

DIVERSIFICATION

Diversification is a very controversial topic in investing. The reason for picking this topic is due to its relevance and more importantly gives you a view of how I think about diversification.

On this topic, we have a wide range of views from the best of investors. Warren Buffett has called it 'protection against ignorance'. Charlie Munger's core argument against diversification is the potential trade-off between safety and returns. Ray Dalio suggests diversifying across 15 uncorrelated assets to reduce the risk-to-return ratio. We then have the Kelly criterion which is a formulaic way to help determine # of stocks and position sizing.

What is right? Who is right?

Diversifying across multiple assets may help mitigate risk and protect against significant losses but may also limit upside.

In my view the right answer lies within what each one of us feel most comfortable with. They are able to sleep at peace OR at least lack of sleep is not related to lack of diversification.

If invested in the stock market, what one can be certain of is there will be volatility. Whether you are an index investor or individual stock picker, you would see price declines of 10% every couple of years and 25% or more approx. every 7 years.

If these are going to rattle you, you should not be invested in the stock market or invest only so much money that it does not bother you. History has proven that the markets are one of the best ways to grow wealth.

Here is what I think about diversification. I have never come across any individual who has 100% of liquid net-worth in one company. Hence to start with, that's off the table. The higher the diversification the lower the returns (exceptions like Peter Lynch exist who had a 29.2% return over 13 years at Magellan Fund).

Also, given a choice to add a new company to the portfolio I look at the existing ones to assess opportunity costs. The intent here being why would I invest in Idea# 12 when Idea# 1 or Idea #2 can perform better. It goes back to confidence in our analysis.

There are always unforeseen and unpredictable events. The advent of technology has further complicated matters. A business that one would think could not be disrupted these days can be easily knocked off. Some of the biggest flyers on Nifty50 in the 1980s do no exist today or in very small ways e.g. Kodak, Xerox , etc.

Given all that, my favorite number is 15 stocks or companies. This is certainly my upper end. I prefer to have fewer stocks in general and this would be reflected in our portfolio at most times.

Diversification to me is also about the type of companies held. For example I would avoid investing in Apple and Foxconn at the same time. Though one can enhance their returns by doing so, when there is trouble with one usually it means trouble for the other.

Hence try and **make investments in unrelated businesses** as far as possible. This does not prevent declines during market meltdowns or recessions but generally when a business has a bad manager, leading to poor results the other businesses in the portfolio do not get affected.

What about my view on diversifying across asset classes? In regard to **real-estate** given my equity in the house I live in, one can consider that to be diversified with real estate. That said, real-estate is not my sweet spot and I have not used it as an investment asset class. I am more comfortable investing in companies or businesses.

As far as investing in **gold**, I am particularly quite opposed to that given I don't think about it as a productive asset class. That said, being an Indian which as a population has the largest privately held gold in the world. I understand the fascination towards this shiny metal and its importance during weddings, etc., If/when I become very wealthy I will end up buying real gold and store it in a locker. The reason being it is disconnected from equities, and in the case of a complete financial meltdown should that happen it should work better than cash.

Bitcoin or crypto is similar to gold in a way with a much shorter track record. Historically, what has survived many generations tends to survive a lot longer than recent ones. Hence I would always pass on bitcoin or other crypto currencies. In recent times with the market meltdown crypto was not spared, suggesting its performance correlates with equities.

Diving deeper into equities, besides making investments in unrelated businesses I think the other aspect to be looked into is Sectoral diversification. Here, what I start with is sectors I can understand and hence would never diversify into sectors that I do not understand for the sake of diversification.

Most businesses tend to be cyclical, hence if all the money is invested in one particular sector chances are you would need to be willing to deal with higher volatility. Again there is no right or wrong answer in my view, just what suits ones personality the best.

Diversification comes in real handy for those who are not comfortable with volatility. The lower the tolerance the higher the need to diversify.

For those who are unable to sustain any volatility most likely are not reading this document and if there is they should be invested in equities at all, and that's totally fine.

CONCLUSION

I expect CVNA to be a multi bagger and I will be monitoring closely to see how the story unfolds. I may include CVNA again in one of our letters about 6-9 months from now.

I would welcome any feedback you may have on this document and as always feel free to reach out to me by email or phone if you have any questions.

We are in this journey together, **our biggest advantage is going to be our collective focus on the long term** along with my skills on capital allocation.

If you have managed to read this document in its entirety itself is one measure of success for me, as unless I receive feedback I will assume it was a reasonably good read.

My next letter would be the Annual Partner Letter for 2023 which I will publish in January. In the interim, I may send you a writeup on how our portfolio is positioned for Artificial Intelligence.

APPENDIX

In regard to the investment thesis document, I want to mention some references that I have used for ideas on writing this document.

Firstly, Nick Sleep and Qais Zakaria (Nomad Investment Partnership), used to provide such documentation to their investors. You would see a common thread across my investment philosophy and how I manage the fund, similar to Nomad's which closed in early 2014 (thankfully, else they would be the best game in town - I would still compete though!!).

Other Tools and websites used-

1) TIKR - Analytical tool to analyze financial metrics

2) CAS Investment Partners - Cliff Sosin's analysis (owns 6% of CVNA)

Thank you for taking the time to read this and as always, if there are any questions please do not hesitate to reach out to me.

Sincerely,

Pratik Kodial