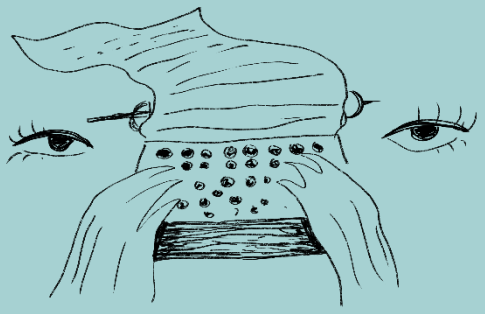
MercadoLibre

An unstoppable growth engine



2022-08-28

MercadoLibre, also known as Meli, is the leading ecommerce player and one of the leading fintech businesses in Latin America. Meli aims to enable ecommerce and several fintech solutions throughout Latin America by delivering a suite of technology solutions across the complete value chains of ecommerce and fintech. Today, Meli operates across 18 countries and maintains a market leading position in each of the major countries in Latin America.

Meli are heavily concentrated on both ecommerce and fintech, so the company could be considered the lovechild of Amazon, Alibaba and Square. Meli's operations stem predominantly from ecommerce marketplaces, logistics, digital payments, and credits. The extensive logistics network arguably makes the business operations more complex and CAPEX demanding which in turn entails a wide moat to the whole ecosystem. Through the business model's dependency on tangible assets on a large scale, Meli has built itself into a position which is very hard to replicate.

The global structural trends for Meli's biggest business units are very strong and have been going on for a long time, with no sign of stopping. Furthermore, the demographic conditions in Latin America suggest that growth for both e-commerce and fintech will continue at a rapid pace for a long time. Meli arguably has a perfect market position to take advantage of this growth.

Key Stats	
CEO	Marcos Galperin
Ticker	MELI
List	Nasdaq
Stock Price	$975
Market Cap	$51,7b
Insider Ownership	~8%

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Content

Key insights

Growth runway

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People

The company is founder-led and the management has a lot of skin in the game as 8% av the company is owned by insiders. Also, the management has a great history of overcoming obstacles as well as for innovation power. Also compelling is the extremely low staff turnover among the management.

Sustainable moat

Meli has created the most complex, expensive, and time-consuming elements for building long-term competitive advantages within ecommerce, being the logistics network and a well-known and trustworthy brand. This is a strength in itself but also provides synergies between their many fantastic businesses.

Investment case

- Strong underlying structural trends both globally but above all locally
- Strong moats that are easy to understand
- Market leader, contributing to the strong competitive advantages
- Long growth runway
- Opportunities for further optionality
- Many catalysts for margin expansion
- Long history of many successes that is among the finest that can be found

Business breakdown

MercadoLibre is the largest online commerce ecosystem in Latin America based on unique visitors and page views. Today, the company is present in 18 countries across Latin America. The Meli platform is designed to provide users with a complete portfolio of services to facilitate commercial transactions both digitally and offline. The business can be broken down into six main segments:

Mercado Libre

The MercadoLibre Marketplace is a fully automated commerce platform which enables Meli, third-party merchants and individuals to list merchandise and conduct sales and purchases digitally. MercadoLibres currently has about 30% ecommerce market share in Latin America. Currently Meli has about 40 million unique marketplace buyers each quarter on their platform.

The marketplace is, and has always been, the core of Meli's business. The marketplace started off as an eBay replica. So, initially Meli was more of an eBay or Alibaba rather than Amazon or JD, since the business model initially was focused towards providing a marketplace rather than first party sales and supply chain management. Meli does not report this number themselves but the numbers I have been presented with say the mix of 3p/1p right now is around 70/30.

As arguably the most well-established of the business segments, you would maybe expect growth to somewhat plateau. However, as technology/internet penetration continues to grow within Latin America, there is still plenty of room for growth.

Meli has several exciting ventures based on its ecommerce platform. For instance, Meli launched a loyalty program called "Mercado Puntos" in Brazil, Argentina, Mexico, Colombia, and Chile in 2019. This program allows buyers to accumulate points ("Puntos") for each purchase made on the Meli platform and by adding balance to their Mercado Pago account (Mercado Pago is Meli's fintech business unit). In turn, this grants access to certain benefits (i.e., free shipping services and better prices) as customers advance through the levels of the program. Meli does not communicate how many subscribers this program has. But the interesting and most important thing about this is that

Meli does not have to reinvent the wheel. Meli can simply learn, both from successes as well as mistakes, from the larger and more mature companies in other parts of the world such as Amazon, Alibaba, and JD – which in my opinion makes the investment case for Meli more appealing since it significantly lowers the execution risk. There are several examples of this, not least Mercado Pago.

Mercado Pago

To complement the MercadoLibre Marketplace and enhance the user experience for both buyers and sellers, Meli developed Mercado Pago, an integrated digital payments solution. Mercado Pago is a full ecosystem of financial technology solutions both in the digital and physical world and was launched in 2003, just four years after the mother company was founded.

Under this business segment, Meli operate several different fintech solutions such as Point of Sale systems, credit solutions for both merchants and consumers, pre-paid cards, digital wallets, and investment accounts.

The asset management product is a critical pillar to build an alternative two-sided network vision. It incentivizes the users to begin to fund their digital wallets with cash as opposed to credit or debit cards given that the return Meli's product offers are greater than traditional checking accounts. Meli also uses the money on these wallets as float to grow their credit business faster at lower interest costs. Without this float, they would have been dependent on more third-party funding.

Currently, Meli has 21 million unique wallet payers and 22 million investment accounts while the population in Latin America is approaching 700 million. In other words, there is plenty of room to keep growing. Mercado Pago is currently available in Argentina, Brazil, Mexico, Colombia, Chile, Uruguay, and Peru.

A huge strength of Meli's fintech operations is that neither Visa nor MasterCard, nor any other actor that processes digital payments, is involved. This applies to Meli's payments both on and off their marketplace/platform. Further, this allows Meli to keep a larger portion of the revenue for their digital payments. This also means that Meli partially can be considered to be a type of Visa/MasterCard in Latin America since about 2/3 of their total payment volume takes place outside their own platform.

This structure of course also entails stronger competitive advantages than if Meli had a position of dependency towards the American giants who usually otherwise charge a "tax" on digital payments – as they particularly do in the US and Europe. The same applies to Meli's debit and credit cards. Meli have financial institution licenses in all the countries they operate in, which allow Meli to issue all cards themselves. All other things being equal, this entails that Meli's fintech operations should be able to have relatively high margin.

Mercado Crédito

Mercado Crédito is Meli's credit solution. It leverages the user base, which is not only loyal and engaged, but has also been underserved or overlooked historically by financial institutions and suffers from a lack of access to needed credit. Facilitating credit is a key service overlay that enables Meli to further strengthen the engagement and lock-in rate of its users, while also generating additional touchpoints and incentives to use Mercado Pago as an end-to-end financial solution.

For Mercado Crédito, Meli have funding partners such as Citi and Goldman Sachs. They are not involved in the lending operation itself, only in the funding part. There are a few reasons for this. First, Meli does not want to limit the growth of the business by depending only on balance sheet funding. Also, Meli use third party funding to share and limit the risk (and gains) of this operation. Meli's long-term idea for Mercado Crédito is to gradually use less third-party funding and more balance sheet funding as the business grows. This will also, like many other things for Meli, increase the margin over time.

The credit service solves the regional problem of most people needing access to credit to build and scale small businesses, as well as for consumers to get credit easily at decent terms. This plays an important role in the overall Meli ecosystem as the flywheel simply spins much faster with the help of credits for both merchants and consumers. This also contributes to increased consumer mind share and loyalty from both merchants and consumers, deepening the moat.

The direct effect of the credit business is an increase in small businesses selling on the platform, which leads to an increase in product selection, which in turn helps to attract more consumers visiting the platform and more consumers using Meli's digital payment solution and logistic services – as aforementioned, fueling the flywheel.

Brazil is Meli's largest and most important market as 56% of total revenue in Q2'22 came from Brazil. The financial system in Brazil is currently controlled by five major banks. Together, these major banks control ~80% of the domestic credit market, according to the Brazilian central bank. This oligopoly has led to a grateful and comfortable position for the banks, which have been able to operate with relatively high margins as the average interest rate for lending in Brazil is among the highest in the world.

According to The World Bank (2021), the average lending rate in Brazil is 30%. This metric consists of both mortgages and consumer credits. Moreover, only 30 – 50% of the population in Latin America over the age of 15 have an account with a financial institution (Riveros, 2022). This means that Brazil's economy is waiting for services like Mercado Pago, which will democratize a large part of the economy and the credit market. This is also one of the main reasons why Mercado Pago is growing so fast. In Q2'22, Meli's fintech operations grew revenue by 107% y/y.

In the last two years alone, Meli's fintech operations have grown from 34% to 46% of the company's total revenue. In parallel with fintech becoming an increasingly larger part of the company, Meli may soon reach an inflection point where revenue growth for the whole group accelerates.

Mercado Envios

The Mercado Envios logistics solution enables sellers on the Meli platform to utilize third-party carriers and other logistics service providers, while also providing them with fulfillment and warehousing services. The logistics services they offer are an integral part of the overall value proposition as they reduce friction between buyers and sellers and allow Meli to have greater control over the full user experience.

Envios operates a very similar model to Amazon and JD logistics, with a mixture of solutions including fulfillment, drop-shipping and last mile delivery. At its core, Envios is a powerful tool to connect locations, buyers and sellers. You can find almost everything on Meli and have it delivered to

your house fast, especially if you are in some of the larger cities. Some of them have one day shipping for almost all products.

Meli now operates as the logistic provider for 91% of the transactions taking place on their platform. Fulfillment penetration (when Meli also holds the inventory in their facilities) was ~40% in Q2'22. Part of the recent strategy from management was to double-down on investments in Meli's logistics. As a result of these investments, Meli is currently positioned as the leading logistics service in Latin America. Still, Envios is only available in 6 of 18 countries in which they operate (same countries where Mercado Pago is available).

Meli is building revolutionary logistics networks across Latin America. This physical network gets increasingly more complex, automated, and intelligent by every quarter passing. By looking at the short history of ecommerce, we can state that ecommerce companies that are willing to invest in physical infrastructure are the ones to dominate the industry.

Amazon, Mercadolibre, Coupang, JD, Rakuten and Ozon are some of the market leaders in different regions and countries, and they have all invested a great deal in logistics compared to their peers. Also, there is probably a good reason for why giants like Alibaba, Shopify and Sea Limited also started investing heavily in logistics in recent years. Note that investments in logistics will not necessarily mean owning every part of the value chain. In some lower-tier cities this might not make economic sense. However, we can state that having sufficient control of the distribution channel is critical for delivering a superior customer experience.

What is so interesting about logistics is that the story behind logistics seems to be changing. Both JD in China and Amazon in the US currently demonstrates that logistics will end up being a huge service industry, and we are slowly starting to see the same thing with MercadoLibre. In parallel with outsourcing their own logistic capabilities to other companies, they are also making the physical infrastructure more and more technology dependent which increases its efficiency and its margins. As previously mentioned, this should be considered a business unit that moves things, not just products, which I think will become more apparent in just a few years.

Mercado Ads

Meli's advertising platform, Mercado Ads, enables businesses to promote their products and services on the Meli platform. Brands and sellers can display ads on Meli's webpages through product searches, banner ads or suggested products et cetera.

During the last conference call (Q2'22), Meli stated that they have only begun to scratch the surface of the potential with its advertising operations. Moreover, Osvaldo Gimenez (President of Fintech at Meli) stated that this business has EBIT margins of 70-80%.

To understand the potentially high operating leverage of this business, we need to break down the take rate (the part that Meli generates as revenue from a sale that takes place on the platform). The take rate for ecommerce marketplaces usually consists of several components: 1) commission on sales, 2) ads, 3) payments and 4) logistics. Currently, almost Meli's entire take rate comes from logistics, payments, and commissions since they now lack the benefit of ads. Logistics and payments often have low or no margins because they have an associated cost of sale that almost completely covers the revenue generated.

Usually, revenue received by the take rate attributable to logistics is almost entirely paid out as a cost to fulfill orders. With payments, there is generally a corresponding cost to the banks/credit card issuers to complete the transaction which means that little net margin goes to the platform. Therefore, the net margin from the take rate normally comes from commission on sales and advertising services, while payments and logistics rather build a better customer experience and improves competitive advantages.

Given this take rate structure, the margin is usually very good for 3p sales within ecommerce when you can: 1) Leverage your size against 3p logistic partners or if you operate a big part of the logistics inhouse, as Meli does. 2) Leverage payment fees with your size against banks/issuers of cards or who is responsible for the underlying payment network – which Meli escapes since they own the payment network and issue the cards themselves. 3) Push up the commission on sold goods against the sellers, which is a process that often takes time and which market leaders are normally best at, which Meli is. 4) When you have a well-functioning system for sellers to run ads on the platform.

When we break down the take rate and build an understanding of what creates net margin for ecommerce companies that operate marketplaces, we can state that Meli has all the characteristics to have both strong competitive advantages combined with the potential of having a relatively high margin. For me, this is a big part of the appealing investment case.

As aforementioned, Meli has just started to scratch the surface for their ads business. I think Amazon provides a great benchmark for the potential of ads within ecommerce – Amazon's ad business currently is a $35b revenue run rate business with very low marginal costs attached. Developing and growing the ad business will most likely be a huge part of Meli's future growth and margin expansion.

Mercado Shops

This business segment is similar to what Shopify does. The 'Shops' division enables users to set up their own online stores, with the benefit of having access to all the benefits Meli offers to help sellers. When opening an online store in Mercado Shops, all the payment solutions, logistics, shipping, fulfillment, and sales management provided by Meli becomes available.

This is a great choice for sellers who want to create their own brand identity since they can customize the store with their logo and colors, as well as they can choose from a great variety of templates available. Just like on Shopify, Mercado Shops allows sellers to link their stores with the most powerful resources on digital marketing such as Google Analytics, the Facebook Tracking Pixel, use the data from Search Console, and many more tools.

This is still a small business unit, but it is growing very fast. According to data from Storeleads (2022), Mercado Shops stores increased 72% q/q and 112% y/y in Q2'22, and now has >30,000 active stores. Unfortunately, Meli generally provides very little information about Mercado Shops so much more than this is not known to the public.

Ecommerce

To understand Meli as a company, its history and potential, it is important to understand ecommerce. Ecommerce is growing globally and accounts for an increasing share of total retail on all continents

with each passing year. Further, it has an obvious value proposition for customers, it is very easy to understand and has historically served as a great platform for optionality as we can see among all the ecommerce giants. Alibaba turned into the largest insurance and fintech company in China, Amazon is the largest cloud provider in the world, JD is the most developed logistics player in the world, MercadoLibre and Sea Ltd are both turning into giant fintech companies at the time of writing, and so on.

The aforementioned value proposition for customers stems from lower prices, vaster selection, and greater accessibility for the consumer compared to physical retail. This means that ecommerce saves the consumer both time and money while giving the consumer more choices.

Further, I think it is reasonable to consider the physical part of ecommerce as a protection against potential threats from disruptive technologies. This because someone who is trying to take market share in ecommerce must build up their own logistics network, their own distribution centers, and their own production if they operate B2C. This both takes an enormous amount of time and costs an enormous amount of money.

Moreover, there can be strong competitive advantages hidden in a business reliant on high capital deployment needs. As you probably agree with, the valuation of a company does not only stem from future cash flows. The future cash flow must also be adjusted for its risk and the probability of the future cash flows.

So, almost all of Meli's operations are digitally scalable but relies on a huge physical network which is difficult to replicate. It both has huge CAPEX needs and enormous network effects on top of this. If the tangible assets are tied to the right digital service, like an ecommerce leading platform combined with several fintech solutions, logistics networks are, in my opinion, amazing businesses in many ways.

Further, the network effects evolve in parallel to the increase of digitization when they start carrying some sort of information and when they connect people. For example, I think there are good reasons for why Buffett, who loves moats, invested in airlines (even though he has now sold his last share). It is obvious that he invested in something with strong moats due to the capital intensity, among other things, and that he made a tradeoff between more security for the investment against less potential upside (as he usually does).

Ecommerce and logistics companies fall perfectly well into this category. However, apart from airlines, ecommerce companies have very a digital and scalable distribution model. But the business model shares the characteristics with airlines in terms of being protected by an extensive physical (and digital) infrastructure. One should not forget that the brand recognition also partly stems from the tangible assets, which in turn acts as an enabler for optionality and increases competitive advantages.

Further, Buffett loves long-term trends of which can be trusted to the dawn of time. McDonalds, Amex and Coca-Cola are three great examples. McDonalds and Coca-Cola have been riding the trends of food and liquid while Amex has been riding on the payments trend. It is easy to understand that humans always will need to eat, drink and make payments. I see the same thing for logistics, we will

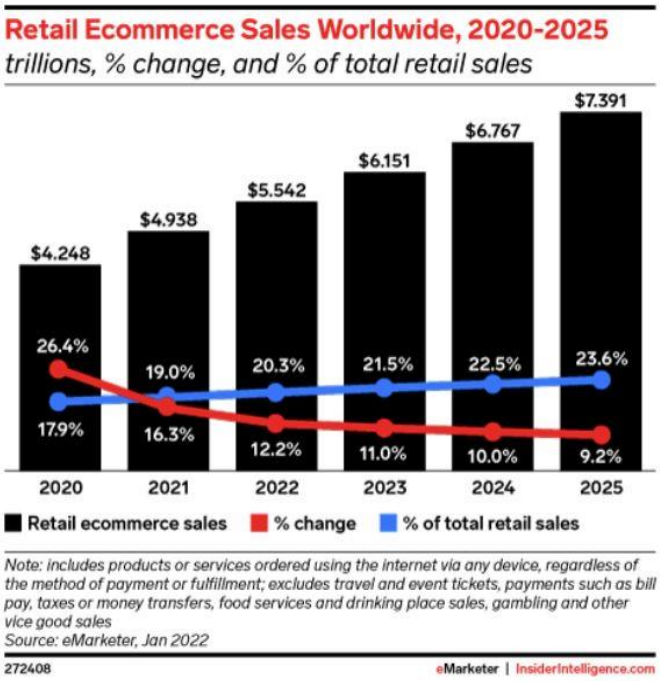
always have to transport things. But apart from the food and drinks trend, logistics and ecommerce have the potential to become fully automated and digitized.

Market Opportunity

When trying to figure out the potential market opportunity available for Meli, it is worth separating out the two distinct areas, ecommerce and fintech. The global market for ecommerce is forecasted to reach $7.4T by 2025, which corresponds to ~12% average annual growth (CAGR) 2020 – 2025. According to eMarketer (2022), ecommerce accounted for 17.9% of total retail sales in 2019. This figure is believed to be 23.6% in 2025 (Cramer-Flood, 2022).

In 2020, Latin America became the world's fastest-growing region for ecommerce. The big winners from this moment have been giants like Meli, Amazon and Sea Ltd, probably due to their strong SEO and logistics.

Latin America's current population is roughly 660 million, and the region has one of the fastest growth rates of internet penetration in the world. This is also critical for the overall investment case.



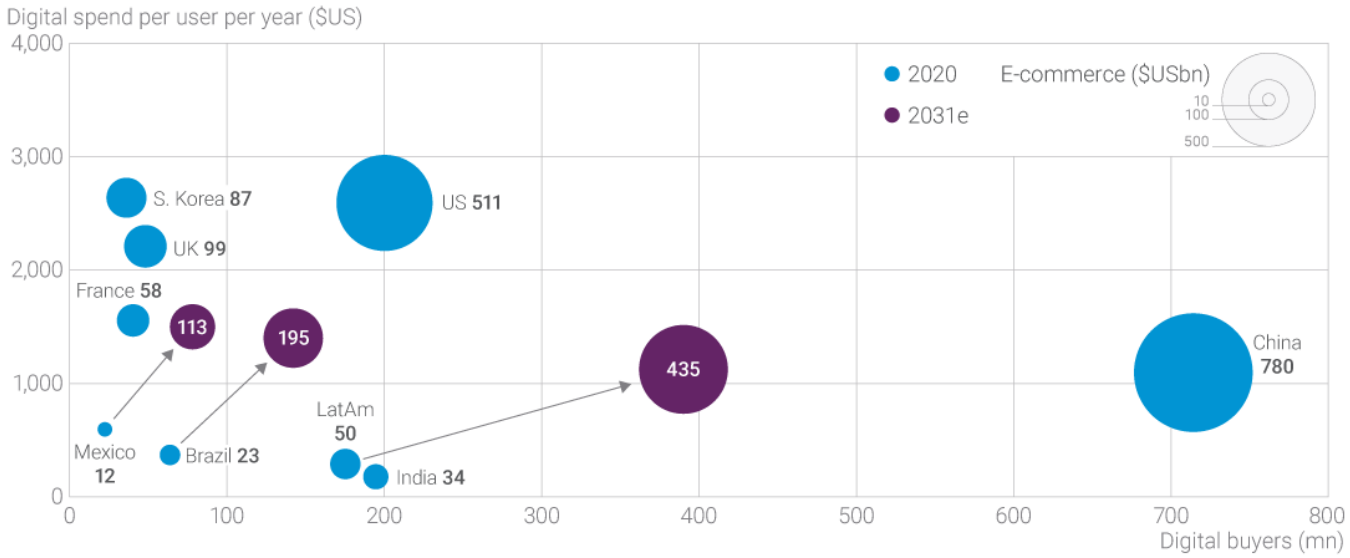
WORLD INTERNET USAGE AND POPULATION STATISTICS 2022 Year Estimates						
World Regions	Population (2022 Est.)	Population % of World	Internet Users 30 June 2022	Penetration Rate (% Pop.)	Growth 2000-2022	Internet World %
Africa	1,394,588,547	17.6 %	601,940,784	43.2 %	13,233 %	11.2 %
Asia	4,352,169,960	54.9 %	2,916,890,209	67.0 %	2,452 %	54.2 %
Europe	837,472,045	10.6 %	747,214,734	89.2 %	611 %	13.9 %
Latin America / Carib.	664,099,841	8.4 %	534,526,057	80.5 %	2,858 %	9.9 %
North America	372,555,585	4.7 %	347,916,694	93.4 %	222 %	6.5 %
Middle East	268,302,801	3.4 %	206,760,743	77.1 %	6,194 %	3.8 %
Oceania / Australia	43,602,955	0.5 %	30,549,185	70.1 %	301 %	0.6 %
WORLD TOTAL	7,932,791,734	100.0 %	5,385,798,406	67.9 %	1,392 %	100.0 %

NOTES: (1) Internet Usage and World Population Statistics estimates are for June 30, 2022. (2) CLICK on each world region name for detailed regional usage information. (3) Demographic (Population) numbers are based on data from the United Nations Population Division. (4) Internet usage information comes from data published by Nielsen Online, by the International Telecommunications Union, by GfK, by local ICT Regulators and other reliable sources. (5) For definitions, navigation help and disclaimers, please refer to the Website Surfing Guide. (6) The information from this website may be cited, giving the due credit to www.internetworldstats.com. Copyright © 2022, Miniwatts Marketing Group. All rights reserved worldwide.

Latin America is relatively speaking a fragmented, competitive market and currently is in a prime moment for ecommerce merchants. Internet penetration in Latin America has never been higher, with approximately four out of five Argentines and Ecuadorians online, along with almost two-thirds of the Brazilian and Mexican population. Venezuela and Colombia are close behind, at almost 70% each (O'Neill, 2022).

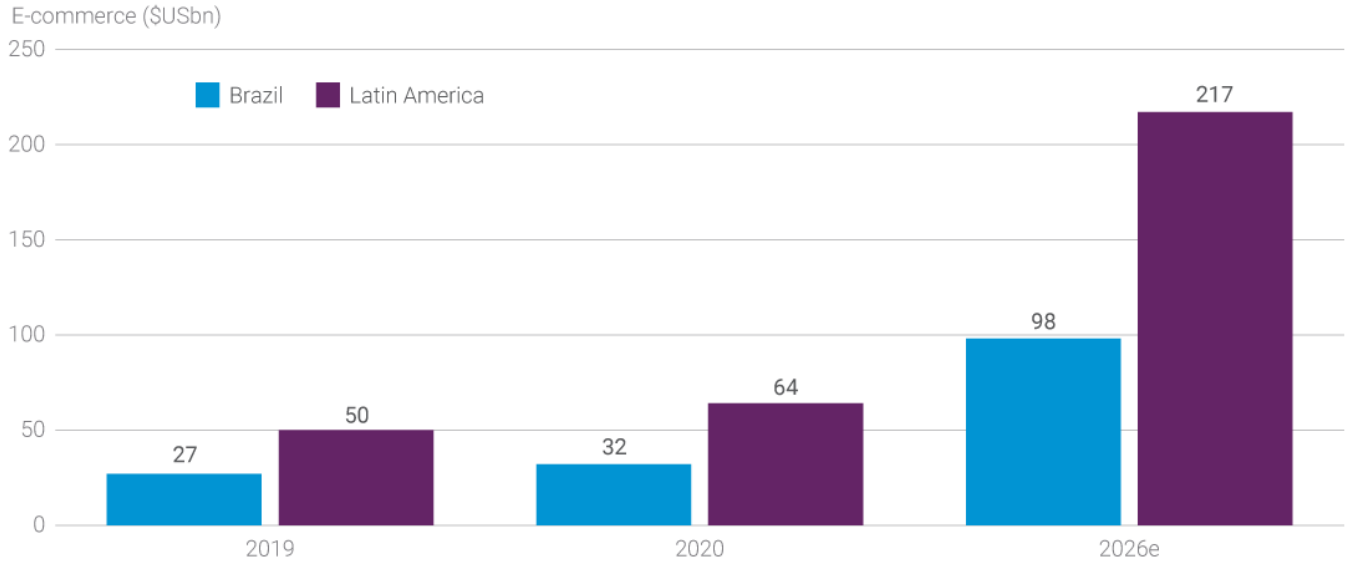
As of January 2021, over 400 million potential ecommerce users were online across 17 countries in Latin America. The pandemic of course accelerated this growth. In fact, the proportion of people shopping online/ecommerce penetration surged to levels the region was not expected to reach for another ten years. The spike shows no sign of slowing, with mobile subscriptions in Latin America expected to rise to 484 million users by 2025 (O'Neill, 2022).

Latin America has a tremendous opportunity for growth, both regarding the number of new digital buyers and how much those buyers spend online on average. Forecasts from Lazard Asset Management (2021) call for the number of digital buyers to increase from 172 million to 435 million by 2031, while digital spend per buyer is expected to increase roughly 3.5x over the same period (C. Boyle, 2021).



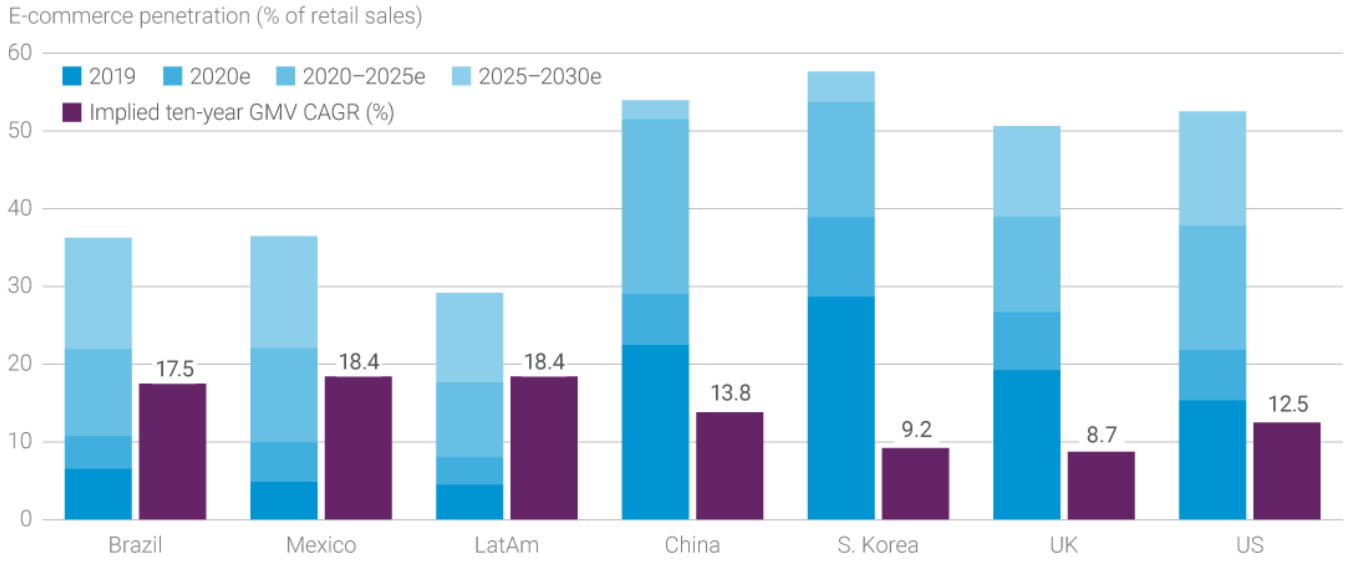
Source: HSBC (2021)

Yet another measure of ecommerce progress, gross merchandise value (GMV), or the total value of merchandise sold by online retailers, is also set to soar in Latin America. Forecasts call for GMV to expand by a factor of 3 – 3.5x until 2026 in dollar terms.



Source: HSBC (2021)

The predicted compound annual growth rate over 10 years, at 18.4%, is one of the highest in the world.



Source: HSBC (2021)

The Latin American market for digital payments and other fintech solutions overlaps a lot with the forecasts for ecommerce. But it is worth mentioning that Brazil is becoming a hub for fintech and digital innovation which should accelerate the overall adoption and growth for fintech. Especially as the fintech disrupters are focusing on mass market and SME lending, targeting the approximately 50 million of Brazil's 215 million population which remains unbanked. According to Forbes (2022), approximately 50% of the Latin America population is underbanked (Salas, 2022).

"Latin America had to adapt during the pandemic. You couldn't pay with cash, so companies had to reinvent themselves and provide new ways of collection. People switched from cash to digital wallets."

- Ignacio Munoz De Cote, Head of Latin American Solutions, J.P. Morgan Payments

Although Brazil has one of the highest numbers of fintech startups in the world, the companies with payment offerings as well as credit track record tools are fast becoming the most successful fintech businesses, Mercado Pago included. Some traditional banking groups are also embracing digitization, helping to drive growth further. Liberal banking regulations and the launch of PIX, an instant payment platform offered by the Central Bank of Brazil, have also increased the overall digital adoption. To summarize the market opportunity, I think Latin America cannot be ignored from an investing point of view with its 660 million consumers, a growing middle class, and its quickly growing ecommerce and fintech markets.

Competition

As Latin America is developing so quickly, more and more foreign players are looking to get a slice of the pie. Amazon initially entered the region in 2012, Alibaba in 2015 and Shopee (SEA) launched in Brazil in 2019. In addition to this, there are several local actors that are worth keeping an eye on. It is easy to draw the conclusion that competition in the region increases rapidly. Below I give a brief introduction to what I consider as the five toughest competitors and their possible respective competitive edges against Meli.

Shopee

Shopee is Sea Ltd's ecommerce platform and the leading ecommerce platform in Southeast Asia and Taiwan by GMV and revenue. Both demographics and internet growth in Southeast Asia are very similar to Latin America and Shopee is on track to acquire a significant share of this expansion. Shopee has footprints in Latin America including Brazil, Mexico, Chile, Colombia and Argentina.

The Asian company have a slightly different overall strategy than Meli. They aim to get customers onto the platform via the popular games division Garena. Their most popular mobile Battle Royal game Free Fire is a great way to get users involved with their ecosystem. Not only is gaming an important aspect of getting users on-board, the addictive social features surrounding the games also encourage users to open and play the apps multiple times per day.

There are plenty more strategic routes to get people involved and using the platform that Meli simply do not possess. Sea Ltd was born as a gaming company and with that background they have managed to make Shopee best in the world in terms of time spent in app among ecommerce marketplaces through various gamification features. This is clearly something that Shopee does

better than Meli. However, it is not time spent in app that generates revenue and gains market share, although of course it can be argued to be part of generating revenue.

Worryingly for Meli, Shopee's strategy seems to be working. Shopee just reported their numbers for Q2'22. In Brazil, Shopee continued to see strong performance with GAAP revenue increasing by more than 270% y/y and became first by average monthly active users in the shopping category in Brazil in the quarter. Shopee has been ranked first for downloads in the shopping category and time spent in the app in Brazil every quarter during the last year or so.

However, Shopee has significantly worse margins than Meli while the parent company is not profitable. In addition to this, Shopee's most important market is Southeast Asia and they do not have the same physical infrastructure, brand recognition or fintech solutions that Meli has in Latin America. I therefore feel confident that Meli will continue to dominate the region for a long time to come. That said, I view Shopee as the strongest competitor for Meli in the long run along with Amazon.

Amazon

When Amazon first launched in Latin America, it expanded to Mexico where it now sits at the second place in market share only behind Meli. Amazon started with a slow and quiet expansion in Brazil, but since 2019, when they launched Amazon Prime in Brazil, they clearly strengthened their efforts of gaining market share in the country. Leveraging the prime membership and relentless focus on customer experience have gained Amazon a market share of ~10% in Brazil.

I expect Amazon to be even more aggressive going forward. AWS is already a success in Latin America, so they probably already know the region's potential. Meli is in fact a customer to AWS, which could give Amazon some insights in Meli's overall operations as well. I would say that Amazon's competitive advantage over Meli is that they have far more financial muscle and are more developed regarding logistics technology. Also, bundling their ecommerce offering along with Prime Video (and other services) through Amazon Prime is something that have been proven to be a huge competitive edge in other markets. Until today, Meli has fared well against competition from Amazon. However, Amazon's development in Latin America should definitely be watched in order to draw conclusions about Meli's relative strength in the region going forward.

AliExpress

The Chinese ecommerce and fintech giant Alibaba also have presence in Latin America with its subsidiary AliExpress. The core idea of AliExpress is to connect international sellers (mostly Chinese) to local consumers at cheap prices, powered by Alibaba's logistics network Cainiao. AliExpress launched in Latin America in 2021, it is therefore far too early to draw conclusions about their success. But at least we know that Alibaba is a tough and powerful competitor, which makes AliExpress worth lifting as a potential threat for Meli.

During 2021, Alibaba announced that goods bought internationally will start being delivered in up to 7 days, an incredibly fast delivery time as many goods that are bought on AliExpress basically must travel across half the globe. Moreover, Alibaba recently announced that Daniel Zhang, probably the most influential person at Alibaba after Jack Ma, will take over the responsibility of their international operations. Given how meaningful Daniel Zhang has been for Alibaba with both Tmall and Taobao in

China, this is clearly a sign that their international business operations will now be given much more attention. However, I think that Southeast Asia will be a bigger priority for AliExpress for the coming years since they have a much larger presence there via the subsidiary Lazada.

AliExpress is also starting to apply gamification and live commerce in Brazil, after the great success of this in China. Knowing that Alibaba is the main name in China's Live Commerce, any competitors should watch this move closely, even if it is applied at a smaller scale. In the long term, this will surely be a threat to Meli's margins, just as in the case of Amazon and Sea Ltd.

Americanas and B2W

Americanas is an almost 100 years old Brazilian chain of retail stores, which passed through the hands of different people, finally being turnaround in the 90s/2000s. That turnaround transformed the company into a strong player who followed the trend of digitalization, starting to get involved with ecommerce right in the early innings of it.

Americanas joined forces with another early adopter of Brazilian ecommerce, Submarino, creating the conglomerate B2W in 2006. B2W was one of the first companies to be listed at the Brazilian stock exchange and is a company that is talked about a lot on Brazilian FinTwit.

Americanas mainly sells 1P and has its edge in more high-end SKUs like tech products with good quality. Their logistics are not that good, and price is average, but they are getting better especially with cashback programs linked to their fintech arm AME. The innovation from Americanas comes mainly from initiatives like Groceries Delivery and Live Commerce. Americanas has been increasingly testing Live Commerce with promos and famous people advertising for it. Once again, this seems to be a future trend of Latin America's tech space.

Americanas has more than 1700 physical stores, ranging from capitals to some of the smallest cities. Those are commonly addressed as memes in Brazil due to the low quality of service. As a result, the company has started to put more resources into their digital offerings.

All in all, Americanas/B2W is a consolidated player and without a doubt has a strong consumer mind share in Brazil. Regarding market share, the company has around 17% of the Brazilian ecommerce market. However, it suffers, and has always suffered from super low margins, the margin expansion is something that is yet to be proved by the company. This also means that they do not have the same opportunities to reinvest capital as, for example, Meli.

Magazine Luiza (Magalu)

If you heard of Magalu, you probably know it as the superapp wannabe in Brazil. Although it is true, the company is probably better defined as the best omnichannel play in Brazil. Magazine is a turnaround that went well. It almost went bankrupt with its old model of physical stores, but the company survived and managed to build one of the highest quality marketplaces in Brazil.

Magalu follows the same model as Americanas, being mainly 1P (but still more 3P focused than Americanas). However, its logistics are way better, faster, and more reliable. It also has a fintech, like every other player in Latin America it seems, MagaluPay. It is relatively new, but it already offers credit cards, POS and cashback. Prices and promos are not the best but, like Americanas, it is very unlikely you will have a problem with a purchase on the site.

To sum up the competition and how it affects Meli; Meli acts as an Ant Financial/Amazon hybrid, being the market leader within both fields with amazing track record for over 20 years and a superior track record compared to their local peers. With a large amount of Meli merchants running bank accounts within the platform, the ecosystem has been proven to become very sticky. It would take an extraordinarily large push from Sea Ltd, Amazon or Alibaba to somehow untangle these existing network effects.

All in all, it would require an extremely large investment from competitors to really disrupt Meli, and the market also allows for several winners in both ecommerce and fintech. The biggest competitor right now, in my opinion, is Shopee, which in just a few years could have the same market share as Meli in several countries in Latin America if the trends we see today continue.

Risks

The downside with ecommerce as a business model is the trickiness of being different when it comes to product and the low customer switching costs. The result of this is usually a palpable price war which pushes down the margins. This is kind of the same story as we have witnessed within physical retail for the last 50 years in the US. It is important to remember that a business is only as good as its competitive situations allows it to be. However, the question I have been asking myself is; how does an ecommerce company stay ahead of the curve as current differentiators might become obsolete in the future?

I believe the answer is relentless customer focus and increasing the value proposition by bundling additional products or services – which Meli seems to execute exceptionally well. What consumers want has not changed. It is convenience, selection, price, and entertainment. What changes is how a consumer defines these variables over time.

Convenience was once the closest store, selection was the biggest store, price just had to be good enough and entertainment could for instance be if something extraordinary happened at the shopping location (a shopping event with accompanying entertainment such as music or other performances in some fancy location for example). Now, however, convenience is one-day delivery, selection is millions of online SKUs, price needs to be the lowest in the country if not the world and entertainment is the overall online experience.

Moreover, leading businesses like Amazon are bundling services like video and audio streaming into their core ecommerce offerings which seems to become a trend among other companies within commerce as well. Walmart has for instance started a similar initiative called Walmart + and JD has gone in the same direction with its JD Plus subscription.

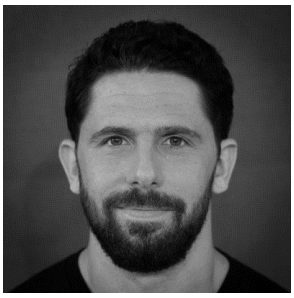
But as other businesses eventually catch up, the question turns to what future differentiation will be. One interesting avenue Meli could invest further in is expanding its private label business. Developing private brands can not only benefit customers, but also benefit the digitization of manufacturers and improve the efficiency of the supply chain. This has become a trend for retailers around the world. Walmart has Marketside, Great Value, George and more; Costco has Kirkland, Chinese supermarket chain Yonghui has "Super Select", JD has Jing Zao and Amazon has several private label brands.

Vertically integrating deeper into the supply-side enables Meli to leverage its vast amounts of consumer data to manufacture products specific to its customers' preferences. Consumers in Latin America already associate Meli's brand with quality. Therefore, I believe it is a natural extension and adjacency for Meli. While private label means lower price for consumers, it is also typically higher margin for the retailer since there is no "brand tax" involved and an additional layer of the supply chain is removed. The opportunity for retailers is found when customers are not sure about brands, and to bundle access to their own private label products. To sum up what I see as they greatest risks is increased competition, with arguably some long-term question marks for a sustainable moat, and what happens to the health of the consumer in Latin America.

Management

Meli has a top management that I believe is strong and sufficient. The company's top management now consists of CEO Marcos Galperin, COO Dan Rabinovich and CFO Pedro Arnt. Beneath these top executives there are a handful of 'Presidents' and Vice-Presidents' who are essentially in charge of the various departments within Meli. Among these are President of Fintech Osvaldo Gimenez and President of Commerce Ariel Szarfsztejn.

CEO Marcos Galperin



COO Dan Rabinovich

CFO Pedro Arnt

President of Fintech Osvaldo Gimenez

President of Commerce Ariel Szarfsztejn

I like several things about the Meli management. First, I like that the company is founder-led and that management has a lot of skin in the game as 8% av the company is owned by insiders. Furthermore, it is appealing how long-term the most important resources have been in the company. For the five management positions mentioned above, the average time working at Meli is 19 years. Galperin, Rabinovich, Arnt and Gimenez have all been with the company since the starting year 1999 while

Szarfsztejn have been with the company since 2017. It is also notable that none of the management personnel, except for Galperin, were as senior as they are today at the company's start. In other words, they have all made great journeys within the company since the start.

The management team also has a great history of overcoming obstacles. About ten years ago, Galperin had an idea of improving the logistics infrastructure within Latin America because it was very deficient in the region at the time. To achieve this, Meli started Mercado Envios in 2013. Over the following years Meli deployed large sums of capital to the venture with the intention of building long-term competitive advantages.

In 2018, Brazil's national postal service raised its prices which resulted in a huge blow for Meli. Instead of backing off when finances were under severe pressure, Galperin decided to invest more into Meli's logistic operations with the goal of expanding fulfillment and free-shipping capacity. This resulted in market share gains for Meli as many competitors were more cautious – what was a risky strategy at the time has clearly paid off today.

Historically, this has proven to be one of Meli's main recipes for success. That is, to act quickly and to reinvest capital in verticals that have proven to be incredibly important in the future. That being said, one can definitely argue that the management is a big part of the investment case and the competitive advantages.

Another strength among the management team is that they possess great understanding of the intricacies of operating within Latin America. Galperin and his team decided early on to adopt a decentralized structure of having different teams for different geographies (Sea Ltd is known for operating in the same decentralized way). This allows the company to be more agile in responding to differences within the regions – adapting product-market fit to the local circumstances.

Given that Meli have created market-leading ancillary services that provide strong synergies to the core business several times for over two decades, we can state that Meli's management is at the forefront both in terms of innovation and capital allocation.

One question mark I see with the management, however, is that several are starting to get older and that some type of change will be needed soon. Anyhow, we have seen that former executive at Meli remain with the company as advisors, which is also appealing for the long-term case. Also, Meli can be considered the life work of the three highest executives, Galperin, Rabinovich and Arnt – since they have been part of the company since it was born. I therefore find it hard to believe that they will not be involved even if they were to stop being operational on paper, because the incentives are clearly far more powerful than purely monetary.

Balance Sheet

Being an ecommerce business with both 3P and 1P segments and having a fintech business with a digital wallet that overlaps across all business units, the company's current debt is mostly focused at keeping its core operations running. The credit business, which is third-party funding intensive, as well as the floating from the Mercado Pago wallets explain the largest part of the current liabilities.

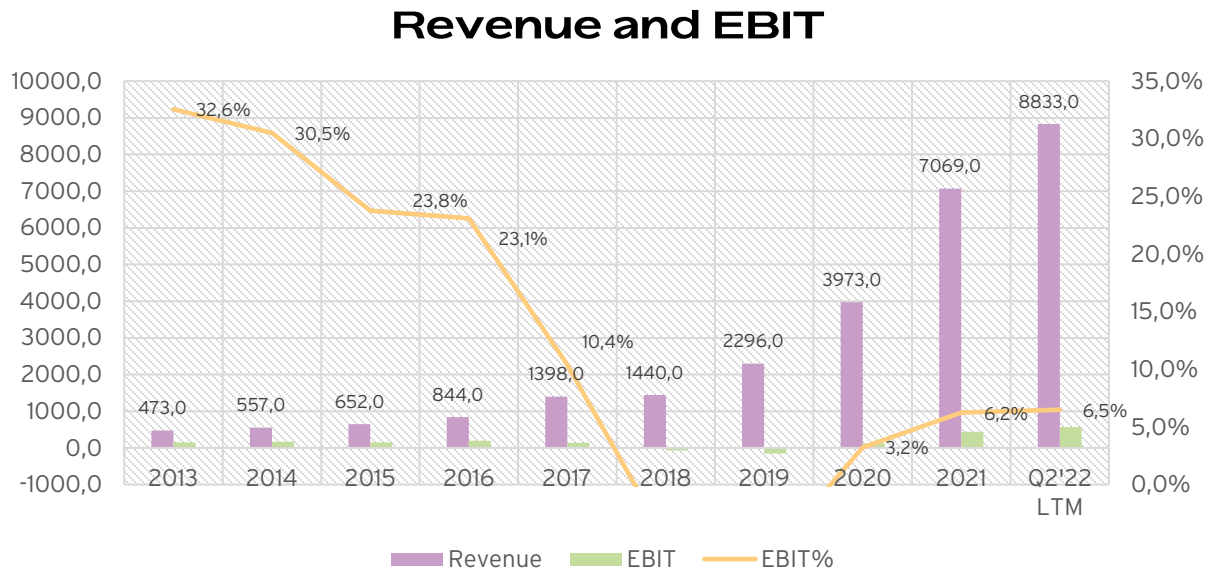
Long term debt is aimed at businesses with longer cash conversion cycles, such as the shipping segment, or even at simply creating safety nets around the company's operations (such as last November's capital raise). Meli's Net Debt/EBITDA ratio has almost exclusively been steady around 3-4x during the last years, which last quarter being closer to 3x due to improvements for the cash conversion cycles (mostly attributable to cash flow from operations).

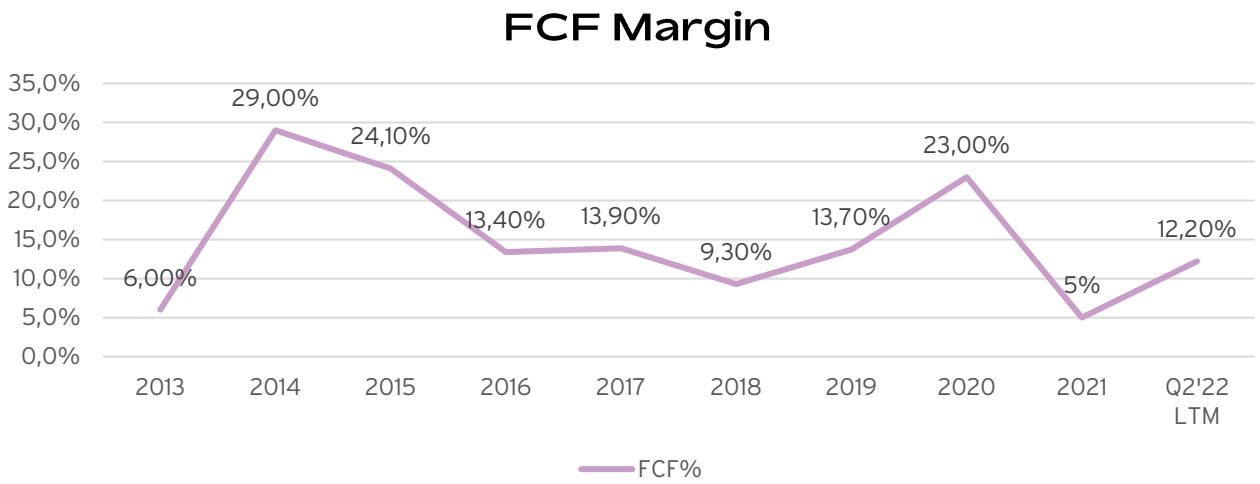
I think the financial stability historically both regarding revenue and FCF margins justifies a slightly higher debt, even though Latin America form a macro standpoint of course appears to be more risky than other regions.

An observation I find impressive is that the company has been able to maintain a sustainable level of leverage without harming growth or profitability. This leveraged cash flow, together with some mathematical effects (for instance adding back the depreciation amounts that correspond to the company's logistic services and numerous leasings) partly explain the conciliation between EBIT and FCF.

Financial history

Looking at the historical financial performance, we find a track record that is truly unique. On Meli's website for investor relations, they have annual reports available from 2007, so I have only been able to look at the history since then. Every year from 2007 until today the company has been cash flow positive (yes, even during 2008 and 2009). Even with this exceptional free cash flow management, the revenue has increased with 104x since 2007. As aforementioned, this history is truly one of a kind.





Valuation

To get a sense of the valuation, I have made forecasts for Meli's income statement (FX neutral) five years into the future and applied what I consider as reasonable exit multiples for 2026. The average sales multiple during the last five years has been 10x. I have chosen an exit multiple of 7x sales, even

though in five years the company will most likely have a better market position and higher margins than it has today. Furthermore, at that time, Meli will primarily be a fintech company, which justifies a higher valuation.

Also, given the history of incredible strong revenue growth and innovation power for over 20 years, and the long history of positive FCF margins along with the long growth runway I think Meli has, I have decided to make a DCF valuation which runs for eight years into the future with a WACC of 8.5%. This gives me a value per share of $1594, which indicates that the company is undervalued today.

Market cap.	51 700
Net debt/cash	2 135
EV	53 835
Share Price	975.22
NOSH	50 418 980

Exit multiples

Sales	7
EBIT	25
FCF	25

Current multiples

Sales	5.9
EBIT	90.3
FCF	48.0

	2021	2022E	2023E	2024E	2025E	2026E
Revenue	**7069**	**10 745**	**15 150**	**20 604**	**26 786**	**34 821**
% y/y	*77.9%*	*52%*	*41%*	*36%*	*30%*	*30%*
Gross Profit	**3005**	**4835**	**7121**	**9684**	**12 857**	**16 714**
**margin*	*42.5%*	*45%*	*47%*	*47%*	*48%*	*48%*
% y/y	*76%*	*60.9%*	*47.3%*	*36%*	*32.8%*	*30%*
EBIT	**441**	**820**	**1450**	**2160**	**3214**	**4527**
**margin*	*6.2%*	*7.6%*	*9.6%*	*10.5%*	*12%*	*13%*
% y/y	*245%*	*85.9%*	*76.8%*	*49%*	*48.8%*	*40.9%*
FCF	**356**	**680**	**1300**	**2060**	**3214**	**4527**
**margin*	*5%*	*6.3%*	*8.6%*	*10%*	*12%*	*13%*
% y/y	*-62%*	*91%*	*91.2%*	*58.5%*	*56%*	*40.9%*

	Enterprise Value / x			
	Sales	GP	EBIT	FCF
2021	7.6	17.9	122.1	151.2
2022E	5.0	11.1	65.7	79.2
2023E	3.6	7.6	37.1	41.4
2024E	2.6	5.6	24.9	26.1
2025E	2.0	4.2	16.8	16.8
2026E	1.5	3.2	11.9	11.9

	Exit multiple		
	Sales	EBIT	FCF
2026E	7	25	25
Weight	33%	33%	34%

	Valuation			
	Sales	EBIT	FCF	Total
2026E	80 437	37 348	38 480	156 264

	Potential Return		
	Factor	Percent	CAGR
2026E	3.02	202%	25%

Margin of safety 30%		
Factor	Percent	CAGR
2.12	112%	16%

DCF Valuation

		2020	2021	2022E	2023E	2024E	2025E	2026E	2027E	2028E	Terminal Value
Free Cash Flow $		935	356	680	1300	2060	3214	4 527	5568	6682	114144
Discount Factor				1,085	1,177	1,277	1,386	1,504	1,631	1,77	1,77
PV of Future FCF				626,7	1104,5	1613,2	2318,9	3010,0	3413,9	3775,1	64488,1
WACC	8,50%										
Perpetual Growth	2,50%										
Today's Value	80 350 400 000										
Shares Out	50 418 980										
Value per share $	**1593,7**										

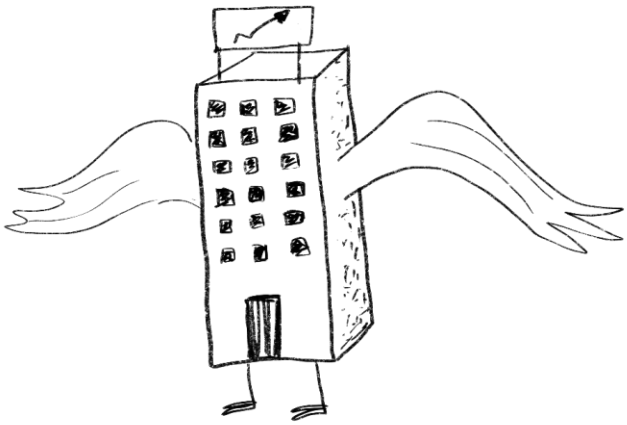
Summary

What is interesting with Meli right now is that the story seems to be changing. They are digitizing their logistics network and are rapidly turning into a digital bank/payment processor. While Meli arguably predominantly is valued as an online retailer today. I think it is reasonable to assume that this narrative will change in parallel to Meli becoming more of a digital bank with enormous synergies from both the marketplace operations and its comprehensive logistics network.

I also believe that Meli will soon reach an inflection point where both CAPEX and OPEX for their logistics operations will not increase as quickly as the marginal benefit for Meli will become lesser (there is hardly high marginal benefit in being able to deliver goods in 18 or 10 hours, for example). On the other hand, there are still many countries to penetrate for Meli in Latin America. The increase in OPEX linked to logistics should also be able to increase more slowly as the physical infrastructure becomes increasingly digitized. This combined with fintech becoming a larger part of the total business should lead to margin expansion, and possibly also multiple expansion.

My thesis is primarily based on three things. First, I believe that Meli has already created one of the most complex, expensive, and time-consuming elements for building long-term competitive advantages within ecommerce being the logistics network. Second, Meli has created a well-known and trustworthy brand for a wide audience which, in addition to being a strength in itself, provides synergies between their many fantastic businesses, deepening the long-term competitive advantages. It is also grateful as a company to be able to add more high-margin businesses on top of the already existing moat such as the ads business. Lastly, the long-term growth opportunities look compelling for all of Melis' business units due to the global structural trends but also to the demographic conditions in Latin America.

All in all, I see several extremely resilient business models that also provide strong synergies to each other just as they obviously work as a good basis for optionality, with maybe the greatest demographic conditions in the world regarding future growth for these various businesses. Behind the wheel of this, I see a management that has an execution history that is top class from a global but above all local perspective.



Disclaimer

The writer holds shares in the company. Nothing you read on Kalqyl.se should be viewed as investment advice. Further, some of the research presented in the article can be wrong or not up to date.

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