# CRYSTAL WATERS PARTNERS

## Market Outlook

August 2021


# SoFi Disrupts Finance

**Short Term Outlook**

Many of our portfolio companies have seen significant valuation pullbacks despite continuing their rapid growth and maturity. Rather than chase what we continue to see as a shorter-term rotation into value stocks, we have continued to expand our positions in our highest conviction growth companies, buying growth at attractive prices with an eye on quality and valuation. We have identified several large, high-quality opportunities that will change industries and people's lives, and as we pursue them with conviction, we are willing to look "wrong" for a while.

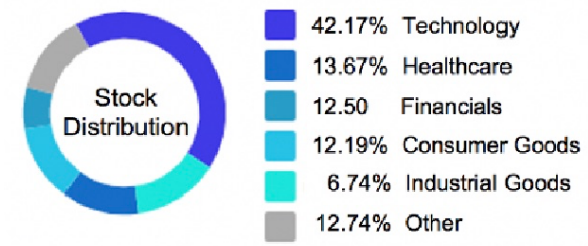
# Portfolio Weighting

The most disruptive companies with the most business upside ahead of them over the next 5-10 years continue to be growth companies in technology and healthcare. Still, we see rapid advances in the financial sector, particularly among FinTech companies gaining market share. These companies typically get rewarded for their growth disproportionately when interest rates are low since a large part of their value comes from future earnings discounted at a lower interest (discount) rate. As rates rise, these future cash flows get discounted more, and value investors are willing to pay decreasing prices for the stocks. We are still in a low-interest environment with the Federal Reserve aiming to keep rates low for at least another year or more.

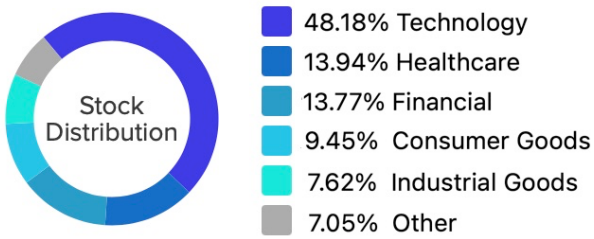
If rates remain low, the fund will favor quality companies in the technology, healthcare, and FinTech sectors. As we see a higher likelihood of rates increasing, we will modify the allocation accordingly.

## Stock Distribution by Sector

July Stock Distribution




August Stock Distribution



# SoFi Disrupts Finance


- **SoFi is a FinTech providing a bank-in-your-pocket to the next generation of consumers**
- **Galileo, which powers other FinTech companies, could become their largest business**
- **Growth is accelerating on all fronts from a flywheel effect**
- **Temporary headwinds make the valuation attractive, long-term fundamentals still in place**

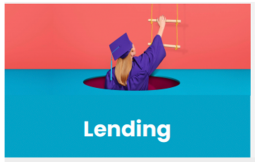
At a time when consumers are increasingly comfortable banking online, and many companies incorporate financial services digitally as part of their online business, SoFi is in the right space at the right time, offering consumers a one-stop shop for borrowing for all life's needs and online investing. It has also packaged up its own banking and online payment processing technology and now provides the underlying technology that powers many of the world's online banks and payment companies.

However, the business is growing fast, becoming a household name. The company came public earlier this year via a Special Purpose Acquisition Company (SPAC) with an initial valuation that, in our view, was too rich for where the business was. After a challenging second quarter due to temporary headwinds and one-time non-cash accounting charges that impacted profitability, the valuation has come down to levels we now find attractive enough for a full position in the fund.

The company operates three separate businesses; 1) Lending, which includes a variety of loans such as student loans, homes loans, auto loans, and more; 2) Financial Services, which offers a brokerage account for investing in public market equities as well as for cryptocurrencies; and 3) a technology platform (Galileo) which is the underlying technology infrastructure that powers

SoFi's lending and financial services business as well as many other FinTech companies. SoFi was originally a customer of Galileo but acquired the company during the depth of the pandemic last year for what is now turning out to be a very low price.

The lending business is the most significant and most mature and is also seeing the lowest growth rate, although 25% per growth is not bad for a company that will soon approach $1 billion in annual revenue. Financial Services is the smallest and also newest business and is still not profitable. Still, the company's projected growth over the next five years is over 150% annually, and this is an area that will begin to contribute materially very soon. We'll describe Galileo in more detail below, but SoFi sees this as possibly their most significant business opportunity.



**Lending**

- Student Loan Refinancing
- Personal Loans
- Home Loans
- Auto Loans
- In-School Loans

GALILEO

**Technology Platform**

Technology infrastructure for building digital banks and other fintech services

**Financial Services**

- Investing
- Crypto Currency Trading
- Retirement
- Wealth Management
- Financial Education

| | Lending | Technology Platform | Financial Services |
|---|---|---|---|
| Revenue | $633 Million (76%) | $166 Million (20%) | $30 Million (4%) |
| Margins | 58% | 62% | Negative – on path to profitability in 2022 |
| CAGR (2020-2025 | 25% | 55% | 150% |

## Business Overview

### 1) A One-Stop-Shop for Loans and Financial Services

More than half of all American's use more than one bank, and clearly, consumers are finding it hard to get all the financial services they need from a single provider, which is what SoFi is looking to change. SoFi started as a student loans business, which is still a core part of the company, but the vision is to provide members a comprehensive set of products that meets all the financial needs of any type of consumer. SoFi looks to establish relationships with customers as early in their lives as possible and offer them new products and services as appropriate, growing with them and becoming their "one-stop-shop" provider. The company has been very aggressive at introducing new products to ensure its members don't need to look around at other providers. As members adopt more products, SoFi's customer acquisition cost decreases significantly, leading to ever-increasing profitability.

### 2) Galileo - the AWS of Fintech

In 2020, SoFi acquired Galileo, a banking-as-a-service company (BaaS). Galileo is similar to how Amazon Web Services (AWS) provides the technology infrastructure for any company

to build large enterprise software systems; Galileo provides all the backend technology required for FinTech companies to accept payments, extend credits, and offer complete bank-like services digitally in a safe and regulatory-compliant manner.

Before the acquisition, SoFi was a Galileo customer, using it to power its banking services. SoFi will continue to use Galileo and build out Galileo's capabilities to become a major technology player. Galileo will enable SoFi to become a significant player in the fast-growing fin-tech market as it supports digital banks, payment processing, investing, cryptocurrencies, and online wealth management.

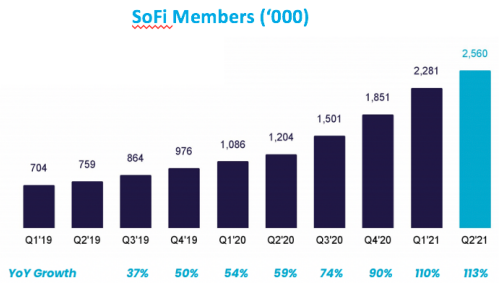

Customers today include some of the biggest names in FinTech, such as Chime, Monzo, KOHO, Revolut, Robinhood, TransferWise, Varo Bank, and many others. Nearly every company doing business online will soon be a FinTech company, at least partially, and will either need Galileo's services or build those themselves. It doesn't make sense for most of these companies to build complex financial services capabilities from scratch. Like AWS, many will use Galileo or a handful of other BaaS platforms to power their fintech services. Accounts have grown almost 120% YoY from 36 million to 79 million and expect similar growth next year.

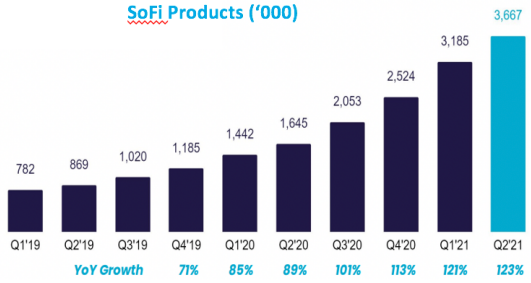
Galileo is currently 20% of total revenue but is projected to grow the fastest over the next five years and eventually become the largest. CEO Anthony Noto remarked that they view Galileo as like Google's acquisition of YouTube or eBay's acquisition of PayPal. He doesn't mean that Galileo will necessarily be the same size as those businesses, but that it's a smaller well-timed acquisition that will eventually become the biggest business in the company.

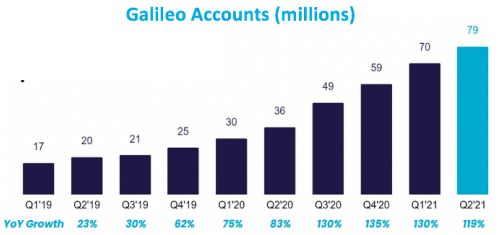
## A Business of Growth

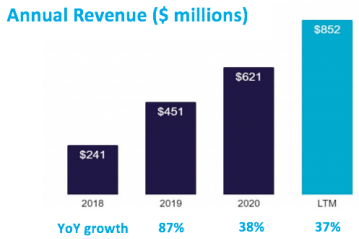
The SoFi business has been on a tear the last few years and is still accelerating, which is why it has caught our attention. Membership growth hit 110% annually, and the number of products (a customer/member using one particular product) is growing 120%+ YoY. Galileo accounts are up

120%, which has led to revenue growth this year of almost 40% through Q2 with a projected run rate for the year of just shy of $1 billion.




Five things are driving the SoFi business forward:

1) **Member growth** - Member growth has accelerated to over 110% YoY, driven mainly by accelerated adoption of digital banking, the availability of cryptocurrency investing, increased brand awareness from going public, and the sponsorship of the L.A. Rams Stadium in Los Angeles.
2) **Customer retention** - The retention rate of members has increased dramatically due to the introduction and adoption of multiple products. If SoFi gets a customer to use 3-4 of your products, then this customer is probably locked in for a long time because switching to other financial providers is just too big of a hassle.
3) **Average Revenue Per User (ARPU)** - The ARPU goes up dramatically when customers use multiple products. However, the customer acquisition cost does not go up linearly, so adding new products to each customer relationship quickly expands margins. The value of being a digital bank where customers log into the mobile app and website every day to check their different accounts is that this daily engagement gives SoFi innumerable opportunities to upsell new products and increase that ARPU. SOFI's customer acquisition cost is only around $50/customer compared to about $1,000/customer for traditional money-center banks.
4) **FinTech Market Growth** – Every company doing business online will need some or all of Galileo's functionality. The question for them is whether they want to build and maintain it themselves or just plug it into one of Galileo's APIs. Most companies are choosing the latter, and SoFi is benefiting.
5) **A Banking Charter – A Catalyst for Greater Profitability**

SoFi has applied for a bank charter, which would allow the company to accept deposits and make more profitable loans using its member deposits. The bank charter would allow SoFi to make loans using deposits on their platform, which would lower their cost of capital and make SoFi's unit economics even more attractive. The bank charter would also remove the need to rely on third-party banks and effectively change the unit economics of their lending business. SoFi estimates that without a bank charter, its adjusted EBITDA (base case) would be $254 million in 2022 but that it would be $447 million with the bank charter, a 76% increase in EBITDA a significant catalyst for the stock.

## Valuation

SoFi is a blend between a new-age digital lender like UpStart (UPST) and a pure FinTech infrastructure company like Marqeta (M.Q.) and has a flavor of both Square (S.Q.) and PayPal. We are confident that SoFi will be worth many times more than today's values 4-5 years from now, but we also have reasonable confidence in the shorter-term risk-reward with as much as 50% upside in the next year. Cross-referencing the valuation from the E.V./Sales multiple comparisons to the company's peers and from a discounted free cash flow analysis gives us about 50% upside from today's levels

### Peer comparison (EV/Sales Multiple) - $20.28 (33% upside 12-month upside)

When looking at its peers, it's clear that SoFi is getting big fast, projected to grow at a 5-year CAGR of 39% compared to 26% average for its peers, so some premium is likely justified. SoFi's gross margins are also higher than the others at 67% compared to 44% on average, and this is likely to grow if/when SoFi receives its banking charter. SoFi currently trades at a discounted 8.3x Sales relative to an average of 13.5 for its peers. We would expect the multiple to expand to be more in line, if not with some pure FinTechs like Marqeta and Upstart, at least with the broader peer universe. Even at a slightly discounted multiple of 12x, we get a share price of ~**$20**

| | Projected Growth (2021 - 2025) | Gross Margins | EV/Sales (2022) | Target EV/Sales | Target Market Cap. ($B) | Target Price/Share |
|---|---|---|---|---|---|---|
| **SOFI** | **39%** | **67%** | **8.3** | **12.0** | **$ 16.20** | **$ 20.28** |
| SQ | 17% | 28% | 5.6 | | | |
| PYPL | 21% | 55% | 10.6 | | | |
| UPST | 25% | 32% | 20.7 | | | |
| MQ | 27% | 39% | 22.3 | | | |
| *Average* | *26%* | *44%* | *13.5* | | | |

### Discounted Free Cashflow - $27.42 (80% upside 12-month upside)

From its torrid growth pace of 30% this year, 50% next year, and 40% in 2023, we conservatively assume significant moderation in growth and a 10-year CAGR of 16%. Margins will begin to expand, but we believe EBITDA will plateau at close to 30% of revenue, which is somewhat lower than other analysts' projections. Capital expenditures will continue to grow, but the majority of the technology investment is in place, and variable costs will become smaller and smaller. Using a

weighted average cost of capital of 7.5%, we get a price per share just north of $27, or almost 80% from current levels.

| *Fiscal Years Ending* | | 21-Dec | | 22-Dec | | 23-Dec | | 24-Dec | | 25-Dec | | 26-Dec | | 27-Dec | | 28-Dec | | 29-Dec | | 30-Dec | Term. Growth % | | Terminal |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Revenue** | $ | **1,005** | $ | **1,512** | $ | **2,128** | $ | **2,824** | $ | **3,389** | $ | **3,813** | $ | **4,099** | $ | **4,242** | $ | **4,327** | $ | **4,413** | | | |
| *% Growth* | | *33.80%* | | *50.40%* | | *40.80%* | | *32.70%* | | *20.00%* | | *12.50%* | | *7.50%* | | *3.50%* | | *2.00%* | | *2.00%* | | | |
| **EBITDA** | $ | **64** | $ | **243** | $ | **426** | $ | **706** | $ | **1,017** | $ | **1,220** | $ | **1,312** | $ | **1,357** | $ | **1,385** | $ | **1,412** | | | |
| *% of Revenue* | | *6.40%* | | *16.10%* | | *20.00%* | | *25.00%* | | *30.00%* | | *32.00%* | | *32.00%* | | *32.00%* | | *32.00%* | | *32.00%* | | | |
| D&A | | -53 | | -80 | | -112 | | -149 | | -179 | | -201 | | -216 | | -224 | | -228 | | -233 | | $ | (4,321) |
| EBIT | $ | 11 | $ | 163 | $ | 314 | $ | 557 | $ | 838 | $ | 1,019 | $ | 1,096 | $ | 1,133 | $ | 1,157 | $ | 1,179 | 2% | $ | 21,870 |
| Pro forma Taxes | $ | (2) | $ | (26) | $ | (66) | $ | (105) | $ | (153) | $ | (188) | $ | (208) | $ | (216) | $ | (220) | $ | (224) | | $ | (4,154) |
| **NOPAT** | $ | **9** | $ | **137** | $ | **248** | $ | **452** | $ | **685** | $ | **831** | $ | **888** | $ | **917** | $ | **937** | $ | **955** | | $ | 17,716 |
| Capital Expenditures | $ | (33) | $ | (49) | $ | (70) | $ | (92) | $ | (111) | $ | (119) | $ | (128) | $ | (138) | $ | (148) | $ | (159) | | $ | (2,955) |
| NWC Investment | $ | - | $ | - | $ | - | $ | - | $ | - | $ | - | $ | - | $ | - | $ | - | $ | - | | $ | - |
| (+) D&A | $ | 53 | $ | 80 | $ | 112 | $ | 149 | $ | 179 | $ | 201 | $ | 216 | $ | 224 | $ | 228 | $ | 233 | | $ | 4,321 |
| **Free Cash Flow** | $ | **29** | $ | **168** | $ | **290** | $ | **509** | $ | **753** | $ | **913** | $ | **975** | $ | **1,004** | $ | **1,016** | $ | **1,029** | | $ | **19,082** |

| **Discount Rate** | | **7.5%** |
|---|---|---|
| PV of Cashflows | $ | 4,388.73 |
| PV of Terminal Value | $ | 19,082 |
| Total Value | $ | 23,470.59 |
| Cash + Debt | $ | (1,559.00) |
| Total Equity Value | $ | 21,911.59 |
| Total outst. Shares | | 799.2 |
| **Equity Value per Share** | $ | **27.42** |

If we take the midpoint of these two approaches, we get a share price of around $23.85. This is a level the price has been at previously this year and given another twelve months is well-within reach again.

| | | **Market Cap** | | **Price/Share** |
|---|---|---|---|---|
| DCF approach | $ | 21,906.11 | $ | 27.42 |
| EV/Sales approach | $ | 16,200.00 | $ | 20.28 |
| **Average** | $ | **19,053.05** | $ | **23.85** |

# Economic Outlook

Powell informed the markets of the Federal Reserve's intention to begin tapering later in the year and not immediately. Additionally, Powell suggested that interest rate hikes should not be expected any time soon, as there is still "ground to cover" before the economy reaches full employment." If the Fed continues to view inflation in the market as transitory, we likely will not see any rate hikes for quite some time. Further supporting the market was the long-awaited Food and Drug Administration's approval of Pfizer's COVID-19 vaccine and the continuation of earnings season, with results coming in better than expected, despite concerns about the delta variant, which has begun to show signs of peaking in select states.

The Institute of Supply Management (ISM) reported that the purchasing managers' index (PMI) for August increased 0.4 percentage points to 59.9%, better than expectations of 58.5%, and marked the 15th straight month of expansion in both the manufacturing sector and the economy overall.

When dealing with people's hard-earned money, you should always be vigilant and on the lookout for potential risks. However, we remain convinced that the scare of a slowdown is overblown, and we are in a new growth cycle. There will be some ups and downs, but the general direction is up. Here's why:

**Growth is undoubtedly slowing, but only from the extreme comparisons of last year's trough. Through a normal lens, growth remains solid.**

- **The Bureau of Economic Analysis reported**, in its "second" reading, reported that real Gross Domestic Product (GDP) adjusted for inflation, our best gauge for economic growth, increased at a seasonally adjusted annual rate of 6.6% in the second quarter of 2021, up from 6.5% in the "advance" reading, however, slightly below expectations for a 6.7% gain.
- **Personal income and spending numbers for July increased**. Personal income increased 1.1% (or $225.9 billion), better than expectations for a 0.3% advance, following a 0.1% increase in June. Disposable personal income also increased 1.1% (or $198.0 billion) in July, following no change in June. August numbers are not currently available.
- **Consumer confidence remains high.** U.S. consumer confidence, as measured by the Consumer Confidence Index, has been high for several months. The Index now stands at 113.8 (1985=100), down from 125.1 in July. This number seems to conflict with all the other data, so we will monitor this and assume that August will get a revision. Stable confidence and rising wages, together with growing household wealth and ample savings, should support high consumer spending.

Still, the economy and markets do face headwinds. Uncertainties remain around the Delta coronavirus variant. While we think the virus' impact on corporate profits or intermediate-term economic growth will likely be limited, it could weigh more heavily on the labor market recovery, thus affecting Fed policy choices. The dismal numbers from the latest jobs report suggest the Fed will need to hold to its current position longer than expected. With the central bank emphasizing its goal of maximum employment and sticking to its view that inflation will be transitory, there is a growing possibility that the Fed is moving too fast on tapering asset purchases.

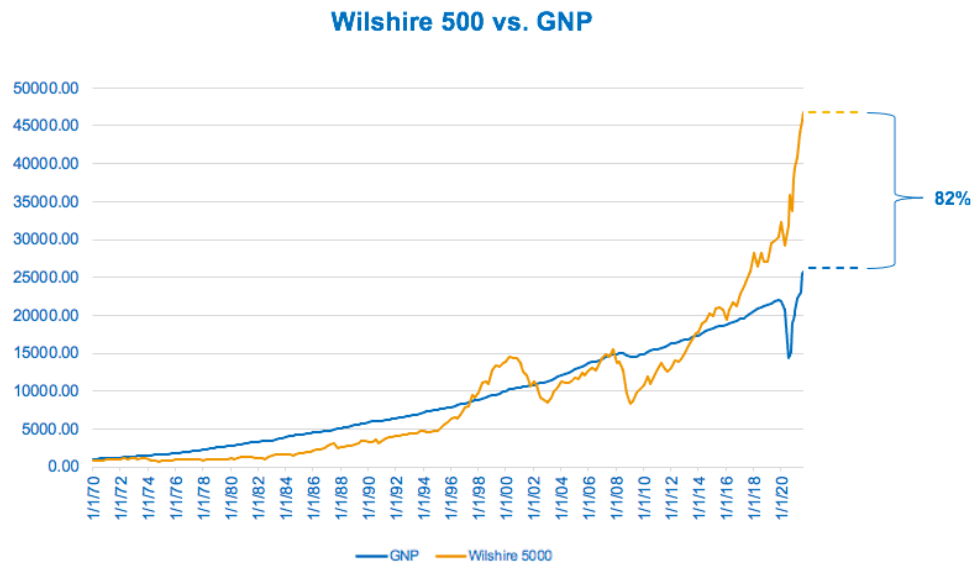
Another risk we are keeping a close eye on comes from China. The country recently stated it wants to improve stability in its domestic financial markets and establish self-reliance in high-tech industries, making clear it plans to grow on its own terms, not those of the West. A slightly more cynical view of that narrative is that the central party is willing to slow the country's growth to address what it sees as threats to control from ever-growing corporations with strong ties to the West. Over the last 3-4 months, this has played out at an accelerated pace. When Ant Group, a part of Alibaba.com, filed for an IPO, the central government saw that this would create the largest financial services company in the world and suspended the offering. Founder Jack Ma, an outspoken figure, has rarely been seen since. Chinese ride-hailing firm Didi, the largest mobility company globally with over 377 million subscribers, which ended Uber's ambitions in China when it bought Uber's China business, was ordered to stop new registrations while the government conducted investigations into anti-competitive practices. Over 30 IPOs have been suspended in August alone as China continues its investigations of monopolistic behavior. The latest move by the central government has been on their entertainment industry.

Xi Jinping was elected president of China for life in 2018 and has shown a willingness to solidify further control, including oppression of Muslims, military advances against Taiwan, and pressure on Hong Kong to give up its independence. Chairman Mao was a revolutionary, and Xi Jinping is an authoritarian, but their language sounds the same. Xi Jinping's approach of attacking ethnic groups, homosexuals, liberal writers, actors, wealthy people, and businesses – all in the name of a homogenous China, controlled tightly by the central party.

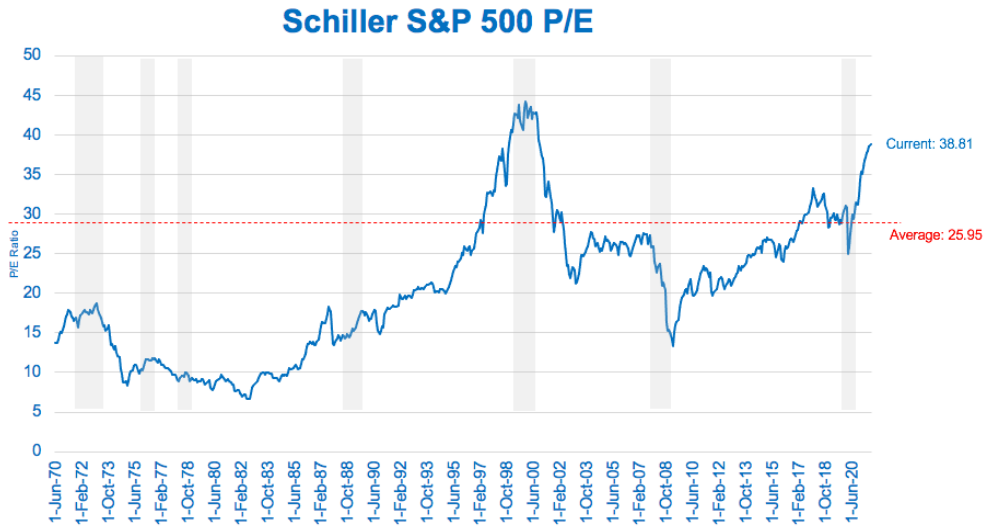
China's change in policy appears permanent and will likely have long-term implications. The impact on investors, particularly CWP investors, is first and foremost through direct investments held in China (e.g., Alibaba). Most Chinese companies will see slower growth and will likely receive far lower valuation multiples from investors. Longer-term, this pivot may weigh heaviest on multinationals and U.S. secular growth companies that have long depended on globalization generally and China specifically for their growth. The semiconductor industry is most at risk from China, principally because of Taiwan's exposure to China policy.

# Market Valuation

The Wilshire 5000 is 82**%** higher than the US GNP, which has been relatively unchanged since last month. While we are still in overvalued territory, we are expecting GNP to hit 6.6% this year. We expect the gap to continue to close unless the broader market exceeds the GNP growth from here.




Interest rates remain low, but even the Shiller P/E Ratio, which adjusts earnings for inflation and interest rates, shows that we are at levels that are historically not sustainable.




The caveat here is that stock prices are forward-looking, and earnings in the ratio use the historical 10-year average. Earnings are expected to grow significantly over the next 1-2 years, which should drive the ratio down, but we are at valuation levels that have our full attention. We are confident that we own high-quality companies that will fare better than the broader market in the long run.

## What Excites Us

### Growth at Reasonable Prices

Growth companies have sold off drastically since March this year. Yet, many of these companies are the fastest growing and most profitable companies with large competitive advantages that give them decades of future above-average growth. At the previous highs, we would have been hesitant to add and increase our cost basis. However, without taking too much risk, we see the current selloff as an opportunity to continue to build the portfolio's positions where we have the strongest convictions.

### Amount of Money Still on the Sidelines

Personal and corporate disposable income is at an all-time high. Some disposable income will go to purchases and capital investments, but some will find their way into the equity market as well. Consumer purchases and corporate capital investments will continue to drive economic growth, while any inflow to the equities market will add further support for stocks. We are conscious that too much liquidity can create a speculative frenzy, but as long as our companies have solid fundamentals, we see the added capital as a benefit to the fund and its L.P.s.

### The Delta Variant

Investors need more clarity to remove the Delta variant overhang. If investors get good reasons to look past Delta, the market will turn into an everything rally. Re-opening stocks should come back strong, commodities may surge again, and consumer spending should grow to historical highs. Come the Fall, and when kids are back to school, the historically high job openings will begin to diminish. The faster positions are filled, the less employers will have to pay up to hire the people they need, raining in the inflation predictions.

## What Keeps Us Up at Night

### Virus Variants drive higher infections

COVID-19 variants are driving infections higher, not only in the U.S. but globally. Any reversion back to last year's lockdowns could be devastating for economic growth. Still, even if lockdowns do not occur, large pockets of infections are impactful enough to disrupt supply chains and keep inflation lingering. Vaccination rates remain too low for herd immunity, and we would like to see the U.S. continue to make progress, especially in the southern states, on vaccinations.

### Rotation to Value Stocks

Money has continued to move to large value-based companies with high current free cash flow and lower growth. Primarily, this is in anticipation of inflation running wild and the Fed having to raise interest rates significantly. We see both inflation and the rotation to value stocks as transitory. Still, we are alert to any signs of permanent supply/demand imbalance that will drive inflation to levels where the Federal Reserve has to raise rates.

### Global Conflicts Impact on U.S. Interests

Two things cause the most upheaval in markets and increase inflation, 1) Interest rate hikes, 2) Wars. According to the Global Conflict Tracker at https://www.cfr.org; there are five critical Conflicts, twelve significant conflicts, and ten limited conflicts that all have a direct bearing on U.S. interests. These are ongoing and will probably be on our radar for months to come.