



Holland Views – Nubank (Price: \$9, MCap: \$43bn)

## Our take on Buffett's Latam flywheel

*"Lowest unit cost wins" Anon*

Long form research is useful, and it has a good shelf life if the analysis is well thought through. Equally important we think is the sharing of ideas. What follows is our reflections on a week or so's work looking at Nubank. This write up will be short for it is a call to action to look at various sources on information that we think insightful. We like what we have found. Think a high ROE disrupter, lowest industry unit costs and a long, long runway for growth and you get the idea.

### Horse's mouth

We noticed in passing last year Berkshire's investment in Nubank but had never looked at the company. Over Christmas we were prompted to do so. Last year your author was asked to be interviewed for Business Breakdown podcasts on two companies he knows well; [Schwab](#) and [Ryanair](#). These are long form discussions that allow authors to explain an investment idea in detail. We enjoyed the process very much. Wanting to learn about Nu Bank we listened to a fellow investor Daniel Bakalarz, who knows Nubank well, do a Business Breakdown on it. We thought it excellent. If all this research piece does is encourage you to listen to the [podcast](#) we are pleased.

The podcast gives a great background as to why the company was set up and crucial insights into the competitive and regulatory environment that brought it to its position today. Summarising such a detailed account of the company will not do this podcast, nor any reader justice. It must be listened to in full.

### [What we think Nubank is](#)

Inspired by Mr Bakalarz we then researched the company for ourselves. We share our reflections below. We have now reverse-engineered a great many Berkshire purchases over the last 15 years and in all cases either learn something insightful about the company concerned or about the investment process itself. Here is where we have got to with Nubank:

- **Nubank is a disrupter business challenging what was a lazy and fat incumbent market.** (Brazilian banks made high profits despite terrible customer service due to large market shares. Everyone put up with this status quo for decades before Nubank challenged it.)
- **It was started and is run by a driven outsider.** David Velez is not Brazilian (he is Columbian) has never worked in banking and does not even speak Portuguese. Seemingly that has not held him back however as from a standing start in 2013 Nubank now has c.50% of Brazil's adult population as customers and 58% of those are using it as their primary bank account!
- **It is a company that has tackled difficult problems first.** Clearly having now huge scale in a country like Brazil means it has first move advantages over other fintech's. Of more importance we assess is that it has full banking licenses and has established itself by starting out in the (hard to get right) lending market, not just by processing risk free transactions (like say Revolut or Monza). The route Nubank has chosen is much harder to do, and thus also we conclude much harder to copy.

- Thus far it has had success with far better credit underwriting outcomes than its established banking peers.
- Arguably this is both surprising and impressive considering its solely online presence.
- **Nubank is a consumer champion, speaking of wanting customers to “love Nubank fanatically.”** So far, they seem to be succeeding in that lofty mission.
  - A large portion of their growth has come from word of mouth i.e. recommendations, not advertising.
  - Their Mexican credit card launched in 2023 has the highest NPS score of any product or service in the world.
- **The runways for growth in front of the company are huge.**
  - Having secured deposit and credit card customers in Brazil they now they have potential to increase significantly the breadth of products offered to these customers who were underserved by established banks.
  - There is also a huge wider Latam market for them to take their offerings to (already in Mexico and Columbia), much of it to people who are currently unbanked.
- **Nubank’s online only presence means it has already established a crucial advantage over incumbent peers in almost all countries. This being its very low efficiency ratio.**
  - Despite the company having much more future growth still to lever over its fixed costs, its current efficiency ratio is already at only 35%!
- **The company is overcapitalised, with total equity being twice the regulatory amounts required by current operations.**
- **The company is under earning on its existing customers meaning the shares are far cheaper than on first glance.**
  - Company charts (see attached presentation pack) show monthly revenue per customer (RPAC) at a current level of \$10. Also, how that has trended upwards over time for each cohort year of new customers.
  - Today’s RPAC is a blend of old (6y) and new customers. It’s \$10pcm level per customer is up from \$7.9 twelve months ago.
  - Crucially, mature customers (even before the company rolls out more products) already produce RPAC’s of c.\$25.
- **We can adjust for this key issue to show what is arguably today’s underlying earning power of the company. Doing so with a revenue per customer of \$15 (not \$25) leads to some interesting conclusions.**
  - Annualized Net Income would be \$2.7bn vs current year market forecast of \$1.1bn.
  - Nubank’s ROE would rise to 45% vs the just reported 21% (itself up from 1% 12m ago).
  - **The resulting PE vs today’s share price is c.16x (\$43bn/\$2.7bn).**

## Who are you? Where are you?

We discussed late last year these two questions and how they are now informing our investment approach. The “*who are you?*” question we have constantly asked ourselves over the years on companies we are assessing. Are you a network with scale? Are you a brand? Are you a scale economy shared business? These are mental models we have spent much time on. What we often spend less time on is “*where are you?*”, i.e., Where are you in your own business maturity or development, or in your investment or regulatory cycle?

### Who is Nubank?

Using this thinking to consider Nubank, the “*who are you question*” is easy we surmise. It is an outsider run, consumer champion disrupter, with a large runway of potential growth ahead of it. We once wrote about looking for businesses as great horses with great jockeys and long runways of growth. On these measures we think Nubank excels.

### Where is Nubank?

A look at Nubank’s last few quarters of performance shows how fast profits have inflected and how analysts forecasts have been slow to reflect the coming operational gearing. The company has clearly been growing customers and market share for some time. But our friend Mr Market likes to see how profitable an enterprise is when it comes to valuing it. Nubank’s financial tables/charts show it has reached a powerful tipping point. With a high fixed cost base, substantial operating leverage is now clearly visible.

- **Mr Market did not see this coming**, and maybe has not fully understood the model and its likely powerful operational gearing outcomes.
  - Analysts increased Nubank’s profit forecast (for all of the next 3 years) by 30% in the last 3 months alone. We think they need to go up a lot more.
- This is no cyclical bump-up or trick of the light, however.
  - It is simply just a maturing of customers resulting in ARPAC of \$10 per customer, up from \$7.8 twelve months ago, and \$4.9 two years ago.
  - Also, in conjunction a greater scale of customers is resulting in a much-reduced efficiency ratio. It is now a mere 35% vs 58% twelve months ago.

Simply put Nubank is at a point in time when its operating leverage is becoming more apparent and thus revealing its underlying earnings power. That is only interesting if an investor thinks such a profit reveal will be better than markets currently discount. We do. The reason for investors to own the shares longer term will be due to Nubank’s defensible, scalable, high return on capital business model. However, the now underway, revealing of its earning power could be a powerful reason to own the shares right now.

## Price... is what you pay

Hopefully readers will see our reflections above (and similar ones made far more eloquently by Daniel Bakalarz on the Business Breakdowns podcast) as sound. Most likely they will then take one look at the valuation of the company (Dec 23 PE: 37x) and decide to ‘pass’ or at least ‘wait’. We think that might well be a mistake.

Our calculation above of the earning power on only the existing customer base has a significant effect on this company’s valuation:

- By upping average revenue per customer from \$10 to \$15 and assuming some operational gearing (but less than the company sees longer term) our 2023 Net income annualised would be \$2.67bn
- This implies a c.16x multiple off of today's \$43bn market cap
  - We think this a very sensible adjustment to make for a company of this nature. i.e. one that has already built huge customer loyalty, but where it takes time for customers earnings power to mature.
  - Also, our assumption of an ARPAC of \$15 could easily be justified as far too low. Today the company's 'mature' customers are actually nothing of the sort as the company itself and products it offers are far from mature.
  - That said they still contribute c.\$25 of revenue per customer per month (i.e. 2.5x today level and 1.7x the figure used in our forecast deriving a PE of 15x).

## Catch me if you can

Clearly Nubank has a good (read 'very good') runway of growth in front of it. The breadth of products it can offer in the Brazilian market is wide and the profit pool very significant. Clearly there is also huge opportunity in the wider Latam market. Its brand, scale, and crucially to us, its very low efficiency ratio will make it hard to compete with. That it has understood a need to both be self-financed and to grow loan books carefully is also good to hear.

Of course, there are competitors, but they also existed as this company grew at c.+100%pa rates for the last decade. Incumbent companies in any sector find it hard to pivot to a new type of offering. Banks have been evidentially very guilty of this throughout the world. Existing branches and cost bases create a "*wouldn't start from here*" problem that becomes harder and harder to solve, not easier.

Fintech competitors by comparison have stolen the easy pickings in low-risk areas like FX payments and money transfers. However, they have not wanted to sign up for full banking licences or run with the capital that is required when one becomes a bank. They have also not been borne out of a lending culture and the risk assessment that is needed with that.

### We look for Sustainable Competitive Advantages...we sense we have found some at Nubank

What excites us about Nubank is therefore its lead over both camps and how each is pretty constrained by an ability to respond/catch up. While competitors tie themselves up in knots this company is compounding at a colossal rate. Despite already having c.50% of the Brazilian credit card market and c.25% of its primary banks accounts it is still growing at a very fast rate. That all said we accept that Nubank is relatively new in its lending life and that mistakes could yet be made.

An important fact we think is evidential but easy to skim over. This being that Nubank as a deposit taking and loan offering bank is genuinely comparable with other global banks. Certainly, that is how its customers see it. With this in mind the important fact is that this company has an efficiency ratio that other banks will likely never be able to match. **As such it has likely the lowest unit costs both in Latam and even globally in a huge sector. This is exactly what we look for.**

*"When you're in a commodity business, the only way to thrive is to be a low-cost producer. And when you're selling money, you're in a commodity business."*

**Duff McDonald**

To some looking at this bank close up it might seem that future ROE type returns are unclear/unknowable. If shown our 45% ROE calculation above they might find many a reason to dismiss it. Yes of course, we realise that such ROEs are high in any regulated bank. However, we also realise what happens if you mix high NIM's with very low cost-income ratios. Very high ROE's is the only logical outcome. That the drivers of these factors look structural, not cyclical and that such a company has an enormous runway of growth gives us plenty of reason to be excited.

Maybe this quote from Peter Lynch is appropriate at this point,..?

***“I don't think that with great stocks you need a super-computer or an advanced Sun microsystems to figure out the math.”***

*Take the example of a company I missed: Wal-Mart. You could have bought Wal-Mart ten years after it went public. Let's say you're a very cautious person. You wait. Now ten years after it went public, it was a twenty-year-old company. This was not a start-up. So it's now ten years after the public offering. You could have bought Wal-Mart and made 30 times your money.*

*The reason you could have done that is that ten years after it went public, it was only in 15% of the United States. And they hadn't even saturated that 15%. So you could say to yourself, now what kind of intelligence does this take? This company has minimal costs, they're efficient, everybody who competes with them says they're great, the products are terrific, the service is terrific, the balance sheet is fine, and they're self-funding. So you say to yourself, why can't they go to 17%? Why can't they go to 21%? Let's take a huge leap of faith: why can't they go to 23%? All they did for the next two decades was roll it out. They didn't change it. I only wish they had started out in Connecticut instead of Arkansas.*

Source: Peter Lynch interview 2002

#### Further reading listening

In addition to the Business breakdowns analysis readers should also listen to David Valez on two further interviews [here](#) and [here](#). Also, to the company's conference calls. Some extracts from the most recent Q3 analyst call are below. This is clearly a company that speaks our language!!

#### Delight the customer

***“The core element of our strategy is very simple. We work extremely hard to make customers love us fanatically as we build what we think are the very best products and services in the markets we operate. This obsession for our customers' experience enables our customer base to expand, both in terms of size and engagement.”***

#### Drive the flywheel

***“These model refinements, in turn, empower us to broaden the scope of our product offerings, reaching even larger segments of the populations we serve. This scale allows us to reduce our operational costs, efficiency which we then decide to pass to our customers via lower prices, helping us provide better products and services at competitive rates, and thus starting the virtuous cycle again.”***

**Lowest cost producer**

*“Now, let's focus on the third pillar of our strategy: achieving a low cost-to-serve. We firmly believe that our most relevant and differentiating competitive advantage lies in maintaining a low cost-to-serve. As we've highlighted in previous discussions, our objective is to sustain our cost-to-serve at or below the US\$1 level for the foreseeable future.”*

Source David Valez, Nubank founder and CEO, Nubank analyst call, Nov 2023(emphasis & heading ours)

Rather than include yet more quotes we have highlighted sections of the Q4 2022 analyst call transcript attached. We think these quotes very revealing as to the corporate culture, operational gearing and likely very high future ROE's.

We think Nubank a very interesting find and encourage readers to get working on it.

Put us down as fans.

Kind regards

**Andrew**

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