Buy MercadoLibre

David Gardner | December 23, 2014 | Buy Recommendation

CURRENT PRICE: MELI $ 971.44 ↑ $ 17.67 (1.9%)

We haven't re-recommended too many companies this year in *Rule Breakers* — just one since February. Don't take that as either good or bad; our goal is to get you invested in the best growth companies we can find, whether that means a new arrival or an old standby. That said, I'm also a big believer in adding to your winners. My recommendation today, **MercadoLibre** (NASDAQ: MELI), gives us the best of both worlds: one of the biggest winners on our scorecard plus one of the best-positioned companies in our orbit.

You may already know MercadoLibre as "the eBay of Latin America," although it's really evolved into a broad e-commerce platform, with auctions, fixed-price sales, third-party storefronts, classified advertising, and more. You may also know it as a stock whose original recommendation here in February 2009, its first of two, has returned nearly 800%.

What you may not appreciate is how well this management team has executed on its vision over the years, leveraging the company's powerful network effect into a competitive advantage that will be hard to overcome. And thanks to a few potent catalysts, we think its growth trajectory is still in its early innings. Don't let MercadoLibre's already impressive record discourage you. Adding shares to your cart today should put you in line for even more growth tomorrow.

Success That Translates

That growth is taking place in Argentina, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, Mexico, Panama, Peru, Portugal, Uruguay, and Venezuela — 13 different countries with 12 different currencies. If you're not a currency trader, you might find headlines from the company's quarterly reports a little confusing. Take the most recent: Growth in U.S. dollars was 20.2% on the top line, 26.1% for operating income. But in local currencies, revenue grew a stunning 89%, and operating income an even more breathtaking 145%.

All these figures are a bit misleading. Because of the high inflation in many of the countries where MercadoLibre operates, growth in local currencies overstates demand — everything is more expensive than it was a year earlier. By the same token, falling exchange rates tend to understate the growth in dollar terms. So instead, let's look at the absolute metrics that signal the strength of the business.

Items sold through MercadoLibre increased 22.3% in the third quarter, while registered users went up 21% to 115.2 million. And transactions processed through the company's payment platform, MercadoPago, rose 48.8% from a year earlier. But step back a little further, and you'll see that not only are more people coming in to buy and sell goods, but those goods are also bringing more profits. It's easy to see why: While MercadoLibre has sunk a lot of money into improving its platform over the past several

WHAT IT DOES

MercadoLibre operates an online marketplace mostly in South and Central America, along with payment, shipping, and fulfillment services.

WHY BUY

- Relatively low penetration in emerging economies leaves plenty of room to grow.
- The introduction of MercadoEnvios shipping, and increasing use of MercadoPago payments, makes the platform easier to use for buyers and sellers.
- The company boasts a strong network effect with operating leverage and wide moat.

KEY DATA

- **Headquarters:** Buenos Aires, Argentina
- **Website:** www.mercadolibre.com
- **Sign of a Breaker:** Top Dog
- **Market Cap:** $5.7 billion
- **Cash/Debt:** $237.5 million / $284.5 million
- **Revenue (TTM):** $529.8 million
- **Earnings (TTM):** $79.2 million
- **Revenue (2011/'12/'13):** $299 million / $374 million / $473 million
- **Earnings (2011/'12/'13):** $77 million / $101 million / $118 million
- **Recent Price:** $128.13

BUYERS GUIDE

- **Industry:** Retail
- **Size:** Mid cap
- **Region:** Latin America
- **Risk:** 5 out of 25 (see all our stocks here)
- **Crushability:** Carbon Steel (see the full scale here)
- **Most similar to:** Zillow

Data as of 12/18/2014

years, all those new users represent next to nothing in incremental costs,
just more volume — and more fees on every marketplace listing, and more commissions on every MercadoPago transaction. So the company's net margin, which stood at 13.7% at the time of our original recommendation, had risen to 24.9% by 2013.

Profits are down sharply this year, but that's due mostly to a one-time, $49.5 million write-off related to the company's Venezuelan assets, as well as investments in the platform. Yet the amount the company spends on general and administrative expenses, and on sales and marketing, continues to fall as a percentage of revenue. I see no reason net margin can't eventually reach 30% as this company continues to grow.

The *Todo* Store?

And there's every reason to think growth will continue. According to the U.S. Commerce Department, online purchases currently represent about 6.6% of total retail sales in this country. Latin America's percentage is reportedly less than half that, suggesting that MercadoLibre will see strong growth simply from more people getting online in the coming years.

But management isn't just sitting back and waiting for new customers to show up. It has relentlessly pushed MercadoPago, such that the payment service is now used to process over 70% of transactions in its largest market, Brazil. (When I first recommended the company in 2009, this figure stood at about 10%). And more recently, it introduced the shipping and fulfillment service MercadoEnvios, starting in Brazil and Argentina in 2013 and just this month expanding to Mexico. After less than two years, it's now used for over 30% of items sold in Brazil.

The idea isn't just to add more commissions — right now, management is more focused on spreading MercadoEnvios than profiting from it, and MercadoPago is a drag on profitability. No, the goal is to reduce the friction of using the marketplace, making shopping, payment, and shipping a seamless and predictable process. In that sense, MercadoLibre has **Amazon.com** (NASDAQ: AMZN) as much in mind as it does minority owner **eBay** (NASDAQ: EBAY).

Add up all these catalysts and you have a pretty straightforward case for long-term success. MercadoLibre is serving emerging economies with growing middle classes and relatively low (but increasing) adoption of e-commerce. It has pricing power for its services and has kept rates pretty stable for the last several years. It has the ability to improve its leverage as it grows. It has a network effect that is a significant bulwark against competition and allows it to continue growing into new vertical markets with different storefronts. It has yet to introduce MercadoPago or MercadoEnvios to all its markets. And it is led by a management team that has proven its ability to execute.

Although the stock is trading near an all-time high, its nearly $5.7 billion market cap is modest in comparison to its opportunity. While we don't expect it to rival the size of $138 billion Amazon or $71 billion eBay anytime soon, this is still a small company with a big footprint in emerging economies.

Risks and When We'd Sell

Venezuela accounted for 18% of MercadoLibre's revenue in 2013. In the most recent quarter, it was down to 6%. That's because Venezuela has allowed its artificially propped-up currency to devalue, and this was the first full quarter reported since MercadoLibre adopted the SICAD II exchange mechanism. That's a painful hit, but one that hopefully puts the currency chaos the country represented in the rearview mirror.

Venezuela represents pretty much a worst-case scenario for the company — a complete currency meltdown that caused MercadoLibre to write off the value of some assets there and see its profits from that country shrink to a fraction of what they had been in dollar terms. We don't expect it to happen again, but that doesn't mean there can't be more woes.

The company's No. 1 market, Brazil, is now experiencing its highest inflation in three years, with annual rates running around 6.75%. But that's nothing compared to No. 2 market Argentina, where inflation is running over 40%, levels not seen since 1991. MercadoLibre isn't operating in the most stable of environments, so big discrepancies between U.S. dollar growth and local currency growth will be a fact of life for the foreseeable future. Much of this is a matter of what happens on paper, but it becomes real to the extent that assets owned by the company are misvalued, or when profits are repatriated to dollars or other currencies. And to the extent that inflation leads to economic instability, that can impact the core business.

In addition, there is the threat of competition from Amazon or the newly public **Alibaba** (NYSE: BABA). That's certainly worth watching, although it's worth recalling that eBay tried to compete with MercadoLibre on its home turf and failed, becoming an investor instead. That's the power of a long head start and a strong network effect.

The Foolish Bottom Line

MercadoLibre's share price has jumped around 50% since the beginning of summer on the strength of its performance even in countries with economic troubles. Even so, the stock has only modestly outperformed the market over the past year — something I believe won't remain true as we enter 2015. Whether or not you've invested in Latin America's marketplace before, now is a great time to shop at the *mercado*.

Karl Thiel contributed to this report.

David Gardner owns shares of Amazon.com and MercadoLibre. David Kretzmann owns shares of Amazon.com, MercadoLibre, and Zillow. Matthew Argersinger owns shares of Amazon.com and MercadoLibre. Simon Erickson owns shares of Amazon.com, MercadoLibre, and Zillow. Simon Erickson has the following options: long January 2016 $90 calls on MercadoLibre and short January 2016 $90 puts on MercadoLibre. Tom Gardner owns shares of Zillow. The Motley Fool owns shares of Amazon.com, eBay, MercadoLibre, and Zillow.