



Square



WILSONS



Afterpay Squared: The Third Horizon



Our weekly view on Australian equities

12 August 2022

A global giant in the making

The pending takeover of Australia's Afterpay (APT.AU) by US-listed fintech Square (SQ.US) has the potential to create a global non-bank financial giant. Both companies are payments specialists – APT for consumers and SQ for merchants – although both are increasingly blurring the lines.

No global fin-tech company has successfully linked both sides of commerce within a single platform or ecosystem.

A third horizon exists for SQ if it can successfully combine, develop and grow its ecosystem beyond a just being point to point payments platform.

A platform offering everything from merchant hardware, payments, merchant services, lending, investing, loyalty and social has the potential to create a network effect in financial services, unlike anything we have seen before.

In our view, investors are only partly attributing any value to what the third horizon of success could look like for SQ, given the potential for SQ's disruptive growth to continue.

A combined SQ/APT could be worth well in excess of the current combined market cap of \$US160bn. For context, SQ peer PayPal (PYPL.US) has a market cap of \$US330bn. Alibaba Group's (9988.HK) ANT Group IPO – the largest and perhaps most integrated consumer/merchant digital commerce platform with 1.3bn users - was earmarked for \$US315bn IPO valuation in November 2020.

We believe the acquisition of APT will accelerate the SQ journey in potentially creating a 'super app'. A platform where consumers/merchants can interact and exchange across a wide selection of financial services.

A combined APT and SQ offers the prospects of +30% revenue growth per year into 2024E, placing SQ in the top quartile of ASX-listed technology companies by revenue growth.

Square unpacked

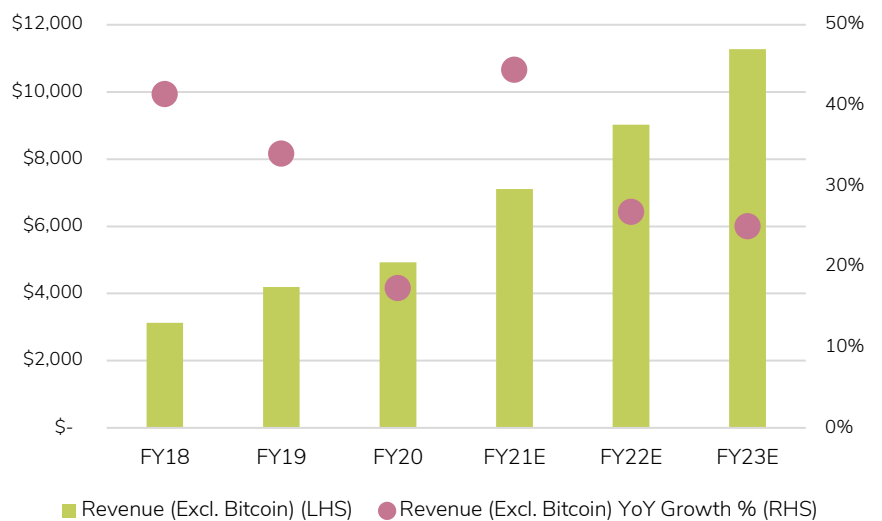
“Some of the magic that we’ve seen in our business is because we’ve blurred the line between those two dimensions... So the more we resist some of the labels of B2C and B2B, that the more optionality we have to build something that is used in unexpected ways...”

SQ is a payments company morphing into a digitally enabled financial services giant. Unlike a bank where earnings predominantly take the form of an interest margin, SQ takes a clip of every service it provides.

A toll-road of financial services, with no (minimal) credit risk. Gross margins are ~80% and should improve as the business increases in scale.

Jack Dorsey, Co-Founder CEO Square

Exhibit 1: Square's Revenue has grown at 34% CAGR since IPO*



Source: Refinitiv, Wilsons. Estimates are yet to incorporate the acquisition of APT, which will add +\$US1.1bn from FY22E onwards. *Net-revenue CAGR 2016-2021.

Merchant services

Square's merchant offering (B2B) is morphing from a simple payments system to an ecosystem of financial services.

The small white mobile card reader that powered SQ's original merchant offer to SMEs, filling the market gap that the major banks and payment rail providers (Visa (V.US)/Mastercard (M.US)) ignored. SQ has now morphed into a platform of financial services that millions of SQ merchants can use.

SQ merchant offering has grown at +20% pa since 2017, and its merchants are steadily increasing in size – improving the unit economics for SQ.

Square's Cash App

SQ's Cash App is a digital bank for consumers. A B2C play for financial services companies to offer services to SQ customers. For many younger customers, the Cash App is a substitute for a bank account. Your employer can pay you via the Cash App, you can forward money to friends and also pay for items online and instore.

The Cash App's main drivers of revenue growth are monetizing products such as brokerage, investing, crypto investing, direct deposits, debit cards, etc.

Two aspects excite us about SQ Cash App:

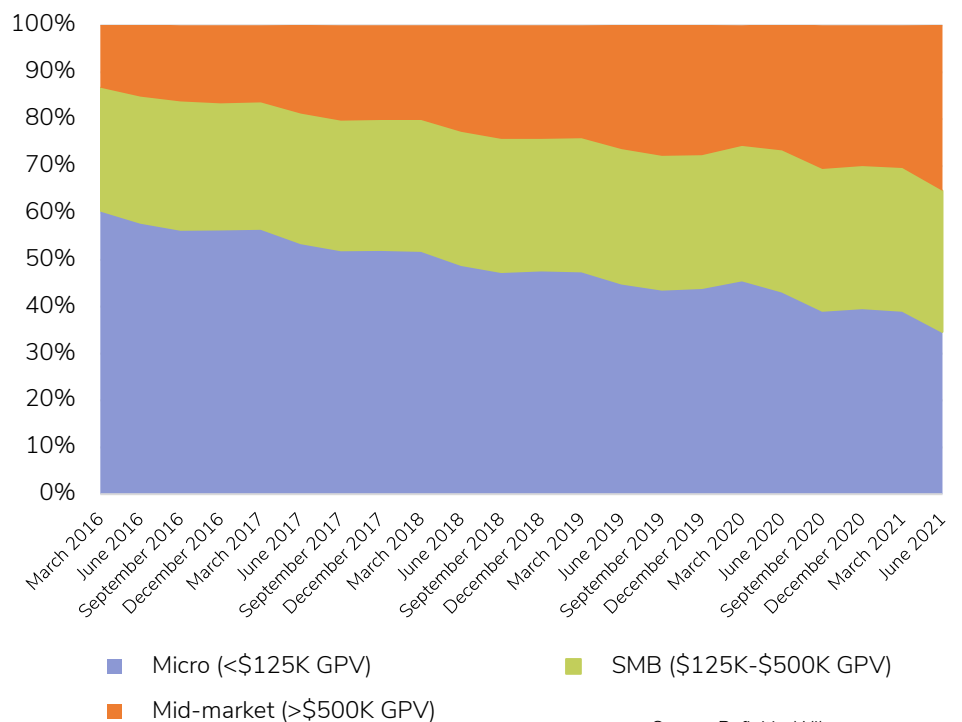
70m active customers. This makes Cash App a 'super app' within financial services. It took SQ 5 years to go from zero to 70m active customers. By comparison, JP Morgan (JPM.US) took over 16 years to convert 70m 'old customers' to digital. Conversion should be simpler and faster than organic customer acquisition. Given the scale of opportunity for monetisation with this user base, the range of services is limited only by SQ's imagination.

A 'third horizon'. Having a large-scale merchant and customer base opens up a new world for SQ to monetise, given the common platform. SQ refers to this area as the 'third horizon'.

Exhibit 2: Square's merchant offer



Exhibit 3: Square's merchant base is increasingly represented by larger SMEs



Source: Refinitiv, Wilsons

In our view, APT represents SQ first move of scale to monetise this opportunity. It is something that APT pioneered with its payments system offering BNPL, but also lead generation for its merchants.

This is why APT could charge 4-6% merchant fees. There is value in connecting merchants and consumers.

Square + Afterpay

“All of these new offerings are ways of bringing money into the ecosystem. When money comes into the ecosystem, customers transact more. When customers transact more, we make more revenue, and there's a very direct correlation between those two things.”

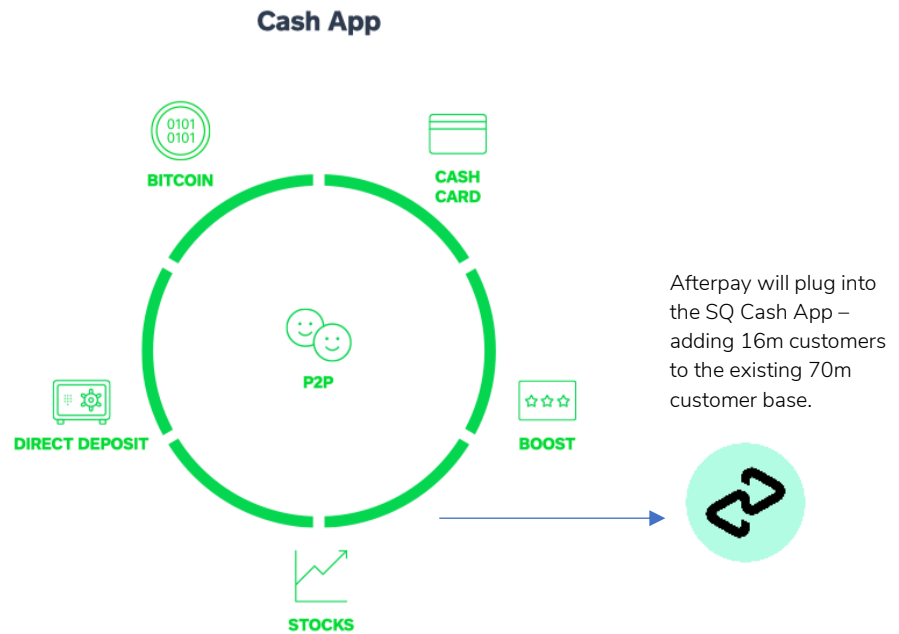
Brian Grassadonia – Lead, Co-creator of Square’s Cash App

APT will add ~ 10% to SQ’s revenue base from CY22E. APT shareholders will receive 0.375 SQ share per APT share and own around 20% of the combined business.

In our view, the combination of APT and SQ could be incredibly powerful for the following reasons:

- APT is long top-tier large global merchants, SQ is underweight large merchants
- SQ needs to continue to build out its Cash App with new functionality. APT’s global BNPL does this. BNPL is the fastest growing area within payments.
- To win globally, APT needs more resources. Governance, global expertise, the capital.
- Both businesses have a Founder focus/entrepreneurial drive and customer-centric.
- Public market comfort – both businesses have grown, raised money and created >98% of their value in public markets - a rarity amongst fin-techs.

Exhibit 4: Square’s Cash App



Source: Afterpay, Square Inc, Wilsons

Exhibit 5: APT will plug into SQ expanding ecosystem, creating a \$US150bn tech player



	Afterpay	Square
Products	BNPL	+30 products, POS, payments, CRM, online, hardware
Merchants	100k	millions
Gross Volume	\$US16bn	\$140bn
Online	>85%	55%
Reach	>50% volume ex US	>85% vol US
Verticals	Retail	Diverse mix
Customers	Millennial/Gen Z, higher income	Millennial/Gen Z
US Geographic Reach	East/West Coast	South/South East US
Founders	Nick Molnar, Anthony Eisen	Jack Dorsey
Rev CAGR 17-21	>150%	34%
Rev CAGR 21-24E	55%	29%
Net Rev FY21E (\$USm)	684	4,840
EBITDA FY21E (\$USm)	33	1,005
Enterprise Value (\$USbn)	28	128

Source: Company data, Refinitiv, Wilsons

Our thoughts on valuation

Valuing APT was divisive for much of its listed life. Australian investors had never seen such a high growth company scale organically to ~\$A1bn revenue in ~5 years.

With little in the way of earnings, revenue multiples became the norm, adopting techniques used in US venture capital and high growth US technology companies (revenue growth >20% CAGR).

SQ relative lack of earnings at present also makes earnings-based valuation measures difficult. Although NASDAQ investors are more familiar with valuing high growth, low earnings fin-tech companies.

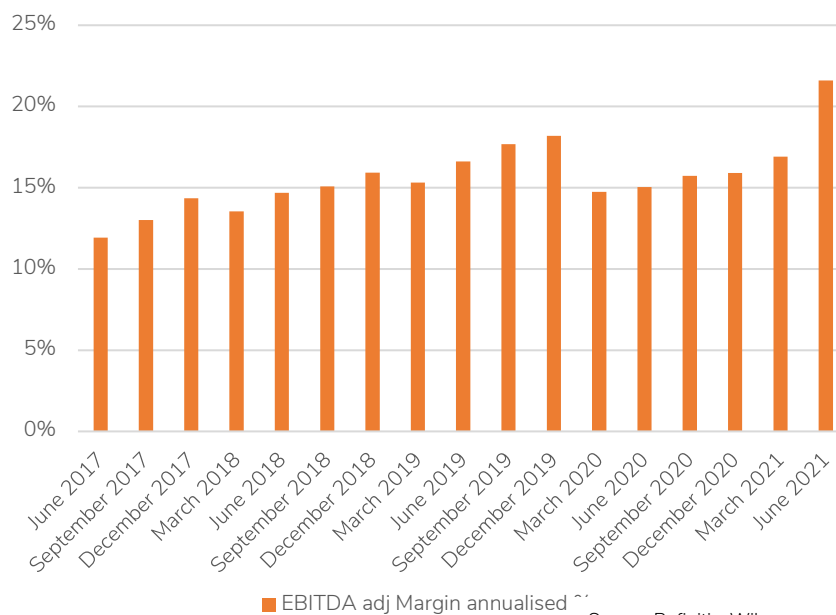
EV/Revenue metrics are the norm, matched up against revenue growth rates. 'Rule 40' (FY1 gross margin + FY1 revenue growth > 40) as a cross-check for quality. A pathway to EBITDA profitability is helpful, but not to the same degree with Australian investors.

SQ is net cash and well through EBITDA breakeven with a \$US1bn expected in 2021, growing to almost \$US2bn by 2023E. EBITDA margins in the last quarter topped 22% for the first time.

SQ currently trades on 14x FY22E EV/Revenue. This is inside the peer average, but a premium to peer PayPal. SQ higher multiple reflective of CAGR revenue FY22-24E of 32% vs 21% for PYPL.

Revenue multiples for US high growth stocks have fallen from 35x in early 2021 and now sit on 23x, where they have since April 21.

Exhibit 6: SQ EBITDA margins broke out in 1Q21, volume and scale benefits assisting.



Source: Refinitiv, Wilsons

An 80% gross margin combined with +30% revenue growth ensures SQ comfortably passes the 'Rule of 40' measure.

An on multiple to growth measure, we take FY23E multiple of 11.5x discount it back by 10% and compare to FY23E growth rate resulting in 0.4x multiple, a discount to peers and large discount to valuation leaders like Adyen (0.9x) and Shopify (0.6x).

Part of the reason investors are prepared to pay high multiples for businesses like SQ is the large Total Addressable Markets (TAM) and disruptive ability to scale quickly and cheaply against legacy operators that appear to slow to react.

SQ talks about the Cash App having a \$US60bn opportunity from 100m customers.

That implies a revenue pool of \$US600pa per user, or a >10x increase vs. the ~\$US50pa SQ currently earns per customer.

“Square has done an unbelievable job of Square Cash. So you’ve had a huge amount of value in what you and I would have called the financial system, which has moved out of the banking system... I look at some of those things very often to say, ‘We could have done that, too,’ and we didn’t.”

James Dimon CEO JP Morgan, JPM 2020 investor presentation.

Focus List and Square

In our view, the prospects for owning SQ in the Focus List remain attractive. SQ remains a high growth disruptive opportunity, which presents a clear challenge to the traditional banks.

The ability to harness a network effect across the merchant and consumer business could unlock significant additional value for SQ – which is currently underappreciated by the market. APT within SQ has the potential to accelerate that journey.

A combined SQ and APT will have a market cap of almost 5x larger APT. This should reduce the share price volatility that plagued APT over the last 12mths, decreasing the stock’s sensitivity to potential capital raisings.

The potential for CGT rollover relief and the ability to own SQ via a CDI, similar to RMD on the ASX, makes the process simple and cost-effective for Australian investors. It is likely an SQ CDI will still be eligible for S&P/ASX 20 index inclusion. The Wilsons Equity Focus List has a 2% weight in APT.

Exhibit 7: Square valuation vs peers

Afterpay/SQ Comparables Table	11/08/2021	EV/Revenue			Sales Growth				EV/EBITDA			Multiple to Growth
Company Name	Mkt Cap \$USbn	FY1	FY2	FY3	FY1	FY2	FY3	CAGR	FY1	FY2	FY3	FY22
Adyen NV	72	71.6x	51.3x	37.6x	96%	40%	37%	55%	117.7x	82.5x	59.9x	0.9
Square Inc	126	17.7x	13.9x	11.1x	44%	27%	25%	32%	119.7x	94.1x	64.9x	0.4
PayPal Holdings Inc	322	12.4x	10.1x	8.3x	20%	23%	21%	21%	42.1x	35.2x	28.6x	0.4
Lightspeed Commerce Inc	16	23.6x	17.6x	12.8x	128%	34%	38%	61%	NM	NM	329.9x	0.3
Affirm Holdings Inc	174	21.3x	15.4x	12.1x	187%	38%	28%	72%	NM	NM	NM	0.4
Shopify Inc	190	39.6x	29.6x	21.8x	58%	34%	35%	42%	261.5x	224.4x	138.4x	0.6
Median		30.4x	22.5x	17.0x	123%	36%	32%	57%	261.5x	224.4x	138.4x	0.5
Afterpay Ltd	29	41.5x	24.8x	17.1x	79%	67%	45%	63%	NM	NM	NM	0.3

Source: Refinitiv, Wilsons, Company data

Disclaimer

Throughout this note, we have discussed what a combined Afterpay and Square entity will look like from an investor perspective. The transaction still needs to go through shareholder approval and various forms of government regulatory approval. There is no guarantee that this will happen. On balance, we think the transaction is more likely than not to proceed.



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Recommendation structure and other definitions

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