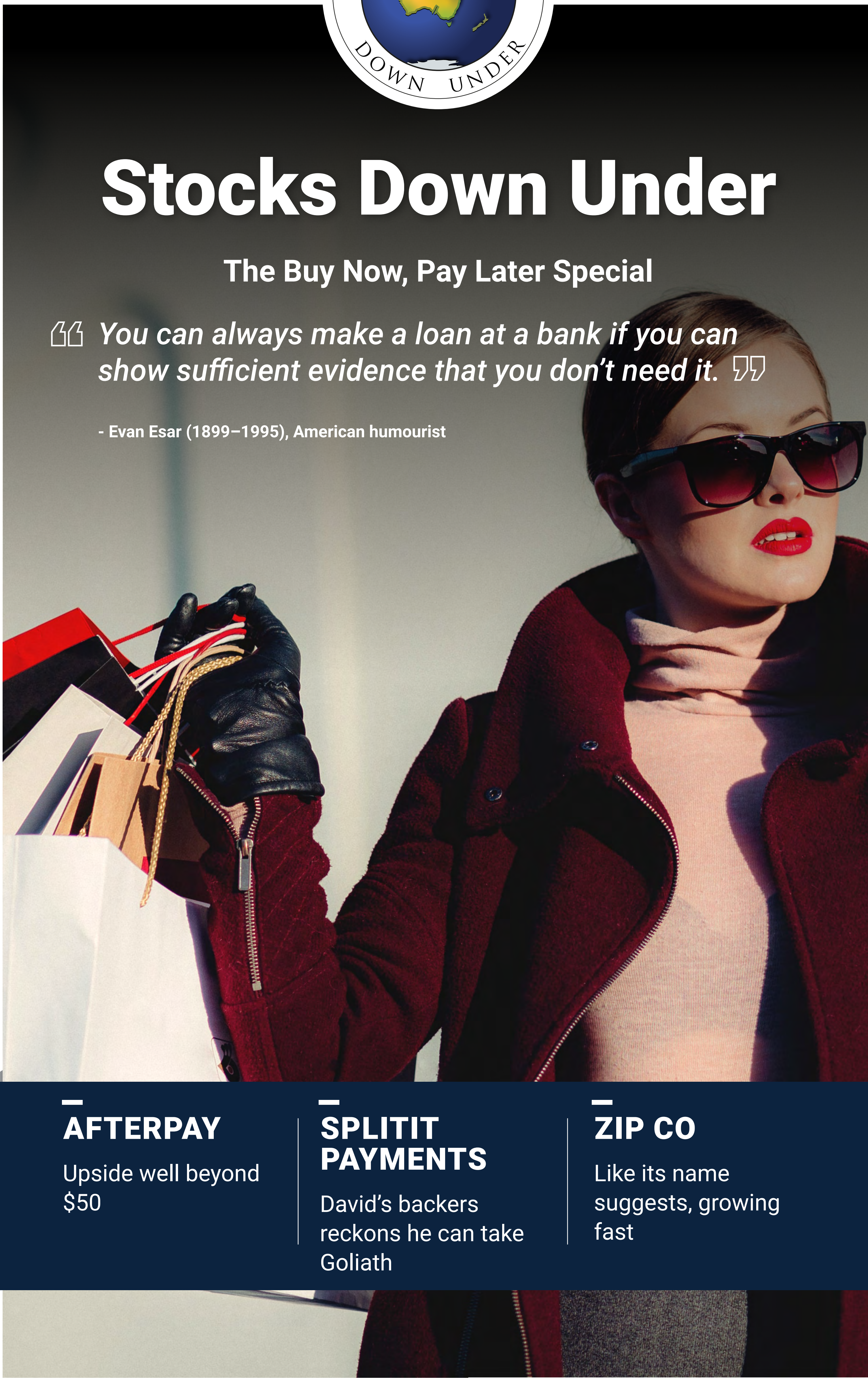
23 APRIL 2020

Stocks Down Under

The Buy Now, Pay Later Special

"You can always make a loan at a bank if you can show sufficient evidence that you don't need it."

- Evan Esar (1899–1995), American humourist



AFTERPAY

Upside well beyond $50

SPLITIT PAYMENTS

David's backers reckons he can take Goliath

ZIP CO

Like its name suggests, growing fast

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Stocks Down Under rating: ★★★★

ASX: APT
Share price: A$ 26.57
Market cap: A$ 7.3BN

We have written about Melbourne-based AfterPay before in Stocks Down Under (see the 5 March 2020 edition). And regular viewers of Friday Beers with Marc & Stuart on the Pitt Street Research website will know that we are quite bullish on the stock. Like most shares, APT went down in the big Corona Crash of March 2020 and reached a low of $8.01 on 23 March. Since then, though, it has bounced back quite remarkably, up 279% to an intraday high of $30.36 on 17 April. Clearly, we're not the only AfterPay bulls.

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Share price: A$ 0.47
Market cap: A$ 146M

When we first wrote about Splitit Payments, one of various companies now vying for a piece of the action of the vast BNPL ecosystem, which AfterPay has created, it was 6 March 2020 and the stock was only 51 cents, way below the $1.62 peak of just a year earlier. The Coronavirus Crisis pummelled Splitit stock down another 57%, to 21.5 cents by 23 March, but the recovery since then has been gratifying. Splitit stock has more than doubled whereas the S&P/ASX200 has struggled back only 13%.

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Share price chart

Source: Tradingview

In a nutshell, AfterPay is a Buy Now, Pay Later (BNPL) company that enables shoppers, both online and offline, to pay for their purchases in four instalments rather than in one payment. These deferred payments are interest free for the shopper as the merchant pays an approximate 3.8% fee for service to AfterPay (that was the margin AfterPay disclosed in the most recent half).

Love it or hate it

When you talk to investors and read the media, both Social and mainstream, there seems to be little middle ground when it comes to opinions on AfterPay. Investors are mostly in one of only two camps: there's the cheerleaders, like us, and then there's the heartfelt haters of AfterPay.

Starting with the nay-sayers, their key issue with AfterPay seems to centre around the risk of additional regulation coming in at some point, which we discussed in our March 5th edition. Simply put, they argue there is a chance that the company may be regulated as a credit provider for the purposes of Australia's National Consumer Credit Protection Act of 2009. We believe AfterPay is already observing these obligations so this added regulation would not inhibit the company's growth prospects in Australia, in our view.

Of course, following the Corona Crash, the bears have another argument to support their case. Given the current global economic circumstances they argue AfterPay's bad debts will increase substantially, i.e. so-called portfolio payment recoveries will deteriorate as more AfterPay users will be in financial trouble. However, as illustrated in the company's 14 April ASX announcement, AfterPay had already tightened its risk framework to focus more on lower risk transactions in March; specifically aiming for lower risk users, with a higher credit score, and lower risk purchases by tightening transaction approval limits. On top of that, AfterPay already prohibited users from making new purchases with AfterPay if they are behind on their existing payments.

Lastly, the AfterPay bears don't like the fact that the company is not turning a profit. We suggest they take a look at the history of Amazon and then get back to us. It took Amazon 6 years from its IPO to turn a profit and even to this day the company reinvests a substantial part of its cashflow back into the business.

The highly scalable business model that AfterPay operates and the need for a landgrab approach to market expansion, given competitive forces, imply that the company invests a lot in a rapid and broad expansion. As with any fast-growing company in this phase of its lifecycle, AfterPay is not optimising its P&L for the highest operating margins, but rather for top line growth. By the way, at a regional level, the Australia/New Zealand part of the business is already cashflow positive and profitable.

AfterPay is channel agnostic

And now for the bull case. During 1HY20 (through December), 76% of AfterPay's underlying sales by retailers in Australia and New Zealand were generated online. However, following the COVID-19 lockdowns, the share of online rose to 88% of underlying global sales in March.

While we expect the economic fallout from COVID-19 to have a limiting effect on AfterPay's growth rate in the next few months and quarters, i.e. growth is likely to be lower but still positive than it would have been without COVID-19, we believe the increased dominance of online as a revenue channel illustrates the robustness of the company's model. In other words, it doesn't matter to AfterPay if consumers shop online or offline, they can still use AfterPay, which we believe is a very big plus.

By the way, after an initial 4% decline in overall underlying sales in the second half of March compared to the first half, the first two weeks of April saw a 10% overall sales increase compared to the second half of March. It seems that after the initial shock to consumer confidence in March, consumers have gotten used to their new reality and have become more comfortable spending again, albeit more online.

Upside well beyond $50

At an EV/EBITDA of 136.6x for FY21, the AfterPay bears argue that this stock is way too expensive. However, we believe AfterPay's valuation is validated by its very strong EBITDA growth rate. In FY21 its EBITDA growth is expected to amount to 186%, followed by 246% and 185% respectively in FY22 and FY23.

Purely looking at FY21, dividing AfterPay's EV/EBITDA by its EBITDA growth yields a ratio of 0.73, which we believe is very attractive as it is well below 1. That ratio only gets better in subsequent years at 0.16 and 0.08 as AfterPay's EV/EBITDA multiple falls to 39.5x for FY22 and 13.9x for FY23.

We asked the question back in March: Can AfterPay shares go to $50? The answer was a resounding yes. But looking at the 2022 and 2023 numbers, we believe there is substantially more upside beyond that.

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Source: Tradingview

As AfterPay's share price recovery has shown, the market seems to have decided that BNPL is here to stay as a standard tool of retailing globally, so popular with consumers, especially Millennial consumers who still have some money to spend, that not even a Coronavirus can stop its rise. The question is who comes next after AfterPay in this extraordinary market opportunity. As you will note above, we like AfterPay. But we are bullish on the whole BNPL space and, reasonably, expect that there will be more than one winner in this space.

Splitit tries harder

Splitit argues that it's the company you should bet on to be Avis going up against Hertz (i.e. a Number 2 that tries harder against a perennial Number 1).

For one thing, Splitit's target market is higher-end, higher-value purchases like jewellery, homewares and high-fashion with an average value of around US$1,000. Over the years, history has shown that a properly positioned luxury brand can withstand any kind of crisis in consumer confidence that would ordinarily kill sales of brands further down the pecking order. If you want proof of that, Google up the case studies of how

General Motors decided to keep Cadillac alive during the Great Depression when a guy from Detroit called Nick Dreystadt looked into why sales were holding up so well.

No Visa restrictions for this traveller

Another thing going Splitit's way is the fact that to use its system you've got to have a Mastercard or a Visa card with an appropriate limit. On 2 March Splitit announced that it was partnering with Visa as part of its global roll out. That's important because Visa's (NYSE:V) has for years been working at being an integral part of the payments landscape you just can't get rid of, even when innovative payments platforms like PayPal are disrupting everyone else. It's reasonable to expect Splitit's powerful friend to be able to open new doors to growth.

The third thing going for Splitit is the fee – merchants only pay 1.5% to go with its system versus the 3.8% or so for AfterPay. This has got to be an attractive proposition for those merchants, while the customers get a good deal because they are charged to the credit card over 2 to 36 months. AfterPay wants the whole thing wrapped up in a mere six weeks.

Covid-19? What Covid-19?

No wonder then, that on 16 March Splitit was able to tell the market that it was experiencing 'no material impact from Covid-19', with new merchants and partnerships continuing to contribute to strong growth. Splitit was also able to point to the fact that it held US$16.3m in cash as at December 2019 and, therefore, was well placed to fund its growth towards profitability for the time being.

The people who run Splitit seem to agree with us that Splitit remains a contender for greatness in the BNPL space with its differentiated offering and its powerful friends. Director Thierry Denis, a former executive of the French payment software and hardware provider Ingenico, has been a recent on-market buyer of stock (23 March), as has Alon Feit, the Israeli founder who had the original Splitit brainwave in 2009 (bought on 30 March). Not only that but Splitit CEO Brad Paterson has also bought some more (31 March), as has Sydney-based angel investor Spiro Pappas (9 April) and Jan Oliver Koelble, who helps run the influential investment club Clade from out of New York (15 April).

Wow. That's a lot of people who know the payments space well and who like Splitit. Splitit is arguably one of the higher-risk propositions in the BNPL landscape because its business is still tiny. However, the rate of growth is strong. Given the credentials of the five men mentioned in the previous paragraph, we're happy for continue following their lead for now. Our view remains Four Stars. Should growth start to slow, however, we'd be nervous.

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Source: Tradingview

If you've seen a funny looking logo at the front of your favourite store that looks like a 'Z' where the top lateral stroke of the letter is replaced by an orange ball, you've come across Zip Co, the creator of ZipPay, ASX Code Z1P (be careful when you plug in that ASX Code – there's a '1' after the 'Z', not an 'I'). What your store is promoting is the ability for ZipPay account holders to buy using what is effectively a line of credit from Zip Co. of either $250, $500 or $1000 that can be spent only at participating retailers. Shoppers can make their repayments either weekly, fortnightly or monthly, as long as a minimum repayment of $40 is made each month. And the credit line is 100% interest free, where interest has been replaced by flat fees. For every month there's a balance owing you're hit with a $6 fee. Fail to cover that payment within three weeks and you're charged another $5. And so on. The company earns revenues from ZipPay through these fees as well as by the merchant fees.

Payment flexibility

ZipPay was actually Zip Co.'s second product. It started out as Zip Money, which was more of a small loans business and is now targeted for purchases over $1,000. The two products together have been strong growers in recent times. In the six months to December 2019 Zip Co.'s revenue more than doubled, to $69.6m, allowing a cash EBITDA of $1.5m.That doubling was achieved with only an 80% increase in Zip customers, so it's fair to say that those customers are becoming more loyal.

Zip reckons its product is better than the competitors because the payment terms are flexible – pay whatever you like each month but beware that the fees add up. More importantly, Zip works to make the mobile experience better than the competitors and the shopping experience is good because the participating retailers can offer deals on the Zip platform.

Managing bad debt risk

The risk with ZipPay is that customers choose to stiff Zip, and in the December 2019 half the company had to swallow a $12m provision, after the $1.5m cash EBITDA, for expected credit losses. As at December 2019 Zip's bad debts were 1.68% of the receivables portfolio, which was about $984m at the end of the half. That $984 had been funded by securitisation warehouses worth $925m with an average interest rate of about 4.3%, and Zip's own resources for the other $60m.

The critics will likely have a field day with that bad debt figure, but that number was down slightly on a year previous. To combat bad debts Zip is investing in internal 'decision technology' that helps it avoid these debtors and we think in the long run this proprietary fintech will pay big dividends. For now, Zip, like AfterPay, is not making a profit while it invests heavily in its growth.

As with Splitit and AfterPay, you wouldn't know there's an economic crisis going on right now if you looked at Zip's numbers – in the March 2020 quarter revenue was up 96%, transaction volume 84% and merchant numbers 58%. Which is why Zip's stock has been able to rebound by about two thirds since the lows last month.

Zipping around the world

More important to us than the resilience of the business in Australia is the fact that Zip is now globalising – the November 2019 capital raising was made in part to fund an expansion into the UK. And recently Zip did a deal with Cotton On, the privately held retailer group that has made the Melbourne businessman Nigel Austin a billionaire, where Zip can introduce its platform into group stores (Cotton On, Supre, Factorie and Typo) in Australia and New Zealand as well as South Africa, the UK and the US.

There's no forecast EBITDA for the next few years to allow an EV/EBITDA multiple for Zip Co. but the stock is currently trading at 7.1x forecast FY21 revenues, dropping to 5.1x FY22. The comparable figures for AfterPay are 15.6x and 6.7x. Given the growth profile of Zip Co. right now, the stock looks inexpensive.

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