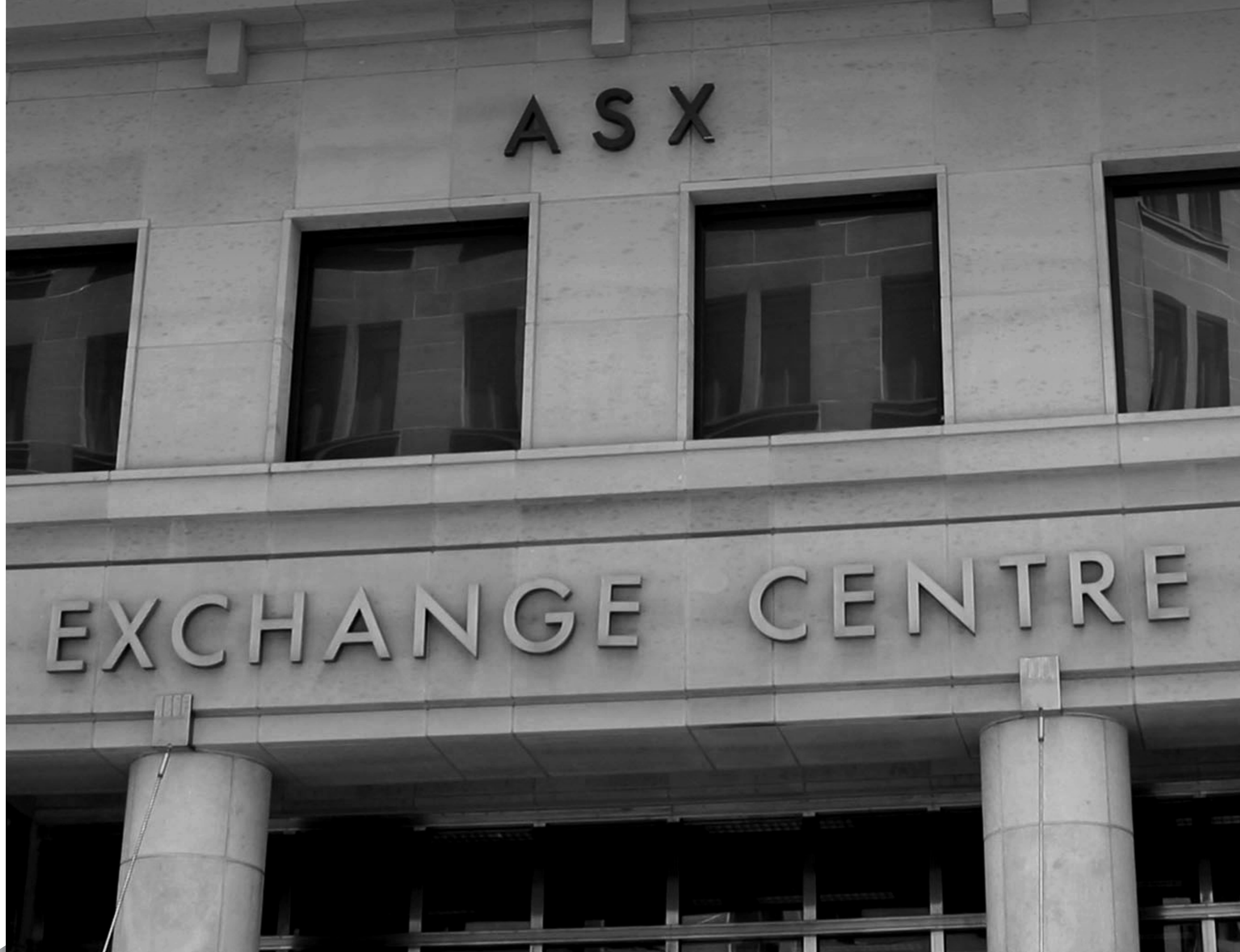
STOCKS DOWN UNDER

2 MAY 2022

ASX Top 200 Stocks Down Under

> *As an investor, my job is to figure out what will happen rather than what should happen.*

- David Einhorn (b. 1968), Greenlight Capital founder and president



BLOCK

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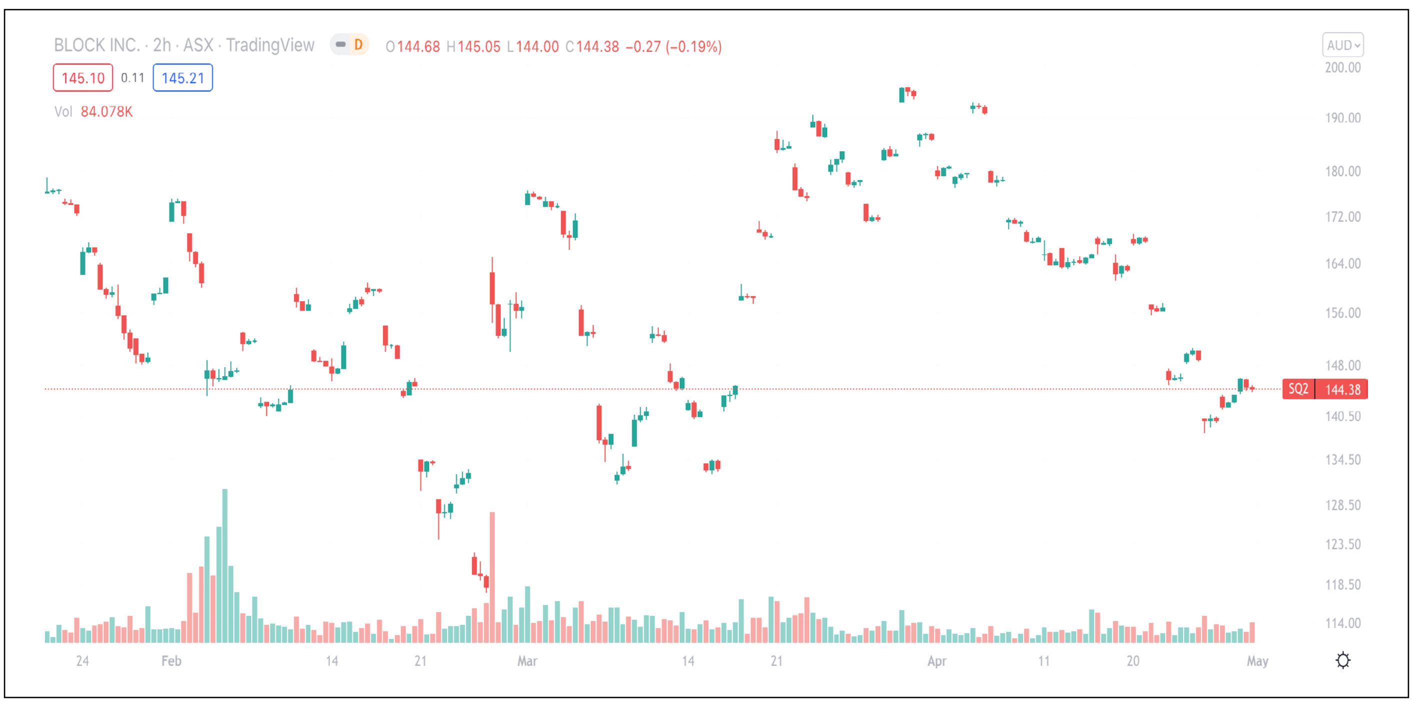
Stocks Down Under rating: ★★

ASX: SQ2
Market cap: A$77.2BN

52-week range: A$116.05 / A$196.00
Share price: A$145.20

The tie up between AfterPay and Block last year seemed a match made in heaven. It offered AfterPay investors the chance for their company to become part of a much larger company at a valuation that marked the largest takeover in Australian history. It also enabled investors to continue to be a part of the journey. It's been a volatile three months, but ultimately tough for shareholders. Is the fate of Block tied up to the rest of the tech sector or can it forge its own path?

Share price chart



Source: Tradingview

What have AfterPay and its shareholders got themselves into?

Australian investors all know AfterPay for its BNPL service, which allows customers to pay for goods over time in instalments. But unlike traditional laybuy services, the consumer receives the goods upfront. Block is a San Francisco-based pioneer in the field of digital payments and the brainchild of Twitter founder Jack Dorsey. Having acquired AfterPay last year in the largest M&A deal in Australia's corporate history, Block has integrated AfterPay into its Cash App, allowing users to pick AfterPay as a payment method. Block's Cash App has over 70 million annual active transacting users who use the app to pay other people, pay for goods or even trade stocks and crypto utilising money transferred from their bank accounts.

Cash App is one of four businesses operated by Block, with its other core business being Square, which helps businesses accept digital payments at the point of sale, through physical terminals. Being a classic Silicon Valley company, Block is experimenting with other ventures. It has a music subscription service called Tidal and a cryptocurrency and decentralized financial ('defi') business named TBD.

Block hit by tech sell off

In recent months, Block shares have substantially retreated in conjunction with the broader technology sector. Its NYSE shares hit an all-time high of US$281.81 on 5 August 2021, but have lost over 60% since then. Block and other tech stocks have dropped because investors are concerned about rapidly rising inflation, which will inevitably lead to central banks increasing interest rates. The US Federal Reserve (Fed) has already flagged multiple interest rates increases in 2022 and it's likely we'll see further increases in 2023.

Rising interest rates tend to hurt tech shares – and growth stocks generally. This is because it means a company's long-term earnings and free cash flow (FCF) growth will be lower and, being the typical way tech stocks are measured rather than short term profits, investors will value these companies lower than they otherwise would. Ultimately, we believe interest rates aren't a significant threat to Block. In fact, the rise of interest rates may actually help the company by increasing the appeal of its interest free BNPL offering for its predominantly millennial and Gen Z customer base. But we believe the bigger elephant in the room is slowing revenue and earnings growth.

Block was a company that benefited from COVID-19 as consumers and businesses pivoted from cash to digital transactions. A report issued by the company in March 2021 indicated the shift away from cash it had observed in the preceding 12 months would have taken three years without the pandemic. Although many users that began using its services during the pandemic will continue to do so, the company isn't seeing as many new users as it did in 2020. A further catalyst is increased operating expenditure, driven by new investments and marketing campaigns.

A hefty premium for slowing growth

Block released its CY2021 earnings on 24 February and the headline figures were strong. The company's EBITDA was US$1.01bn, up 114% from the US$474m made in 2020. And its gross profit from Cash App and Square were both over US$2bn and up over 50% from CY20. But the company's net loss was US$166m and the annual earnings figures masked a slowdown in the company's growth, which began in the second half of CY22. In the September quarter, Block's pre-tax earnings fell from US$360m to US$233m and to US$184m in the December quarter. After recording net income of US$204m and breaking even in the September quarter, it was back in the red by US$77m. The gross profits from Square and Cash App have likewise been slower in 2021.

Consensus estimates forecast Block's full year FY22 EBITDA to be $1.19bn, which would be a 17% decline from the year before. But EBITDA growth should pick up substantially in FY23, to 65%, followed by 35% in FY24 and 57% in FY25. Seen in that light, SQ2's CY23 EV/EBITDA multiple of 43.8x doesn't seem excessive. However, in the very near term, i.e. the current calendar year, we'll need to see if that projected 17% decline in EBITDA is as bad as it will get. So, we are erring on the side of caution in the near term.

We believe it is a big victory for the ASX to have AfterPay taken over by a company with such global significance as Block and to have Block establish a secondary listing rather than take AfterPay's scrip and run. And with digital payments being the big deal they are today, consensus numbers for future years suggest Block will be a growth company in the longer term. But at least in the short term, we rate Block two stars as we lean back and watch FY22 pan out. And despite our rating, we'll be watching what Jack and Company do very carefully.

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