AfterPay: The Journey Ahead

It is great that the market has recognised the potential within Afterpay's business model and subsequently repriced the company substantially since our last blog post. Even though our investment thesis and comparison with Amazon has been questioned by a number of market commentators, it appears as though the broader market in general has now agreed with our analogy.

Brief Summary of Annual Results

Afterpay achieved annualised gross sales of $240 million in the US after only 3 months of trading. We perceive that there will be strong upside going forward as Afterpay builds it's brand recognition amongst customers and availability with merchants over time.

We note the reduction in net transaction losses to 0.4% of gross sales. This demonstrates great practical credit control from the company, as well as the strength, quality and usefulness of their credit database.

Gross sales rose by circa 290%; however, net revenue to the group rose by 390%. This demonstrates the pricing power and scalability evident within the Afterpay business model.

Group Capital (equity+debt) post raise can support annual gross sales of in the region of AUD $5-6 billion. They have guided international sales of circa AUD $1 billion in 12 months; this implies that the ANZ region business may generate circa $4+ billion annualised.

We actually consider this figure conservative given the speed of their customer uptake in the USA. For example, Morphe Brushes a popular cosmetics company started to offer Afterpay as a payment option on the 5th of August. Referral web traffic just from this brand was almost 30% that of Urban Outfitters referral traffic (who have been on the platform since May) just 26 days after offering Afterpay as a payment option. Amazingly, Afterpay's web-mall accounted for over 7% of Morphe Brushes referred traffic in these 26 days; further cementing its reputation as a source of incremental demand for merchants.

The near-term upside from merchant onboarding we expect to be significant with Chemist Warehouse now offering Afterpay in-store. Chemist Warehouse controls 25% of the Australian pharmacy market by revenue to provide some idea of the size of the opportunity. In addition, we note that ASOS Australia will soon be offering Afterpay as a payment option. It is very likely that ASOS will be the cornerstone merchant in the UK market rollout. For context, ASOS has revenue roughly 25% smaller than Urban Outfitters however, has web traffic more than 3 times greater reflecting a more diverse, global clientele.

We consider that the in-store rollout in the US will provide the highest mid-term upside given the majority of retail sales are still made physically, this is in line with Afterpay's Australian experience. In addition, we note that the recent weakness in the Australian dollar will provide a positive tailwind in their overall sales figures.

We anticipate that Afterpay will raise debt facilities in US, sooner than later to fund the US expansion. It makes sense for them to match their assets to their liabilities in terms of currency. The US Private Placement (USPP) Market is very sophisticated relative to the Australian market, and terms are often more flexible at a similar price to major bank financing. This would be a precursor to a NASDAQ listing, as a USPP raise would build awareness amongst institutional investors in the US.

Industry dynamics
We have noted recent chatter in the media regarding the competition in the payment space. From our global study of the industry we have not found a single instance of a truly cost free customer solution comparable to Afterpay's model; with all apparent 'competing' solutions typically charging interest and/or monthly account fees.

We note that the presence of competitors does not necessarily mean that presence of additional risk. On the personal note, I remember using a large number of social media platforms such as MySpace, Friendster, Hi-five, Orkut; all were virtually wiped out once Facebook had achieved traction in the space and are now all practically defunct. This demonstrates that the confluence of factors in terms of usability/satisfaction for customers, networks effects and simplicity/standardization in a product offering can lead to the evolution of a monopoly player or market structure. I believe that this will be the case over time with Afterpay as their market position, brand and credit database, become stronger with every transaction that runs through the platform; providing a sustainable competitive advantage or 'moat'. Afterpay's viral growth amongst consumers and merchants alike is further evidence of it's competitive advantage in the space.

We have been following at the high level the findings of the banking royal commission underway. From our perspective, the majority of unethical behaviour by financial institutions was due to ambiguous terms in the terms and conditions between the financial provider and the consumer; along with a strong dose of human nature. We think Afterpay's vanilla terms and conditions that are clear, precise and concise; along with the fact that the system possesses a very high level of automation, insulates the business from regulatory risk. Funnily enough, we heard a rumour that National Australia Bank (NAB) who provide Afterpay's bank facilities may have had the opportunity to invest in Afterpay at an early stage but passed even though they have a specialised fintech investment mandate. This demonstrates to me one of the single largest advantages smaller companies and investors have over entrenched incumbents.

We noted with interest that just 2 weeks ago Berkshire Hathaway run by Warren Buffet, considered by many to be the epitome of a value investor, made an investment of over $300 million at a valuation of $10 billion in an Indian payment platform company Paytm. This represents a large shift in Berkshire's previously articulated philosophy, and readers should be advised to watch this space closely.

Geographical expansion
As we flagged ambiguously in our last blog post, Afterpay have announced the expansion of the platform into the UK, the world's 3rd largest online retail market. We feel that the strategy to take over an existing company shell with the requisite financial licenses but with no residual exposure to the company's IP or legacy business is a very positive move in terms of executing with speed. From our research this has saved them between 12-24 months of scrutiny from the UK financial services regulator, and we consider the price paid to be fair.

We have come across further evidence in the public domain to support Afterpay's global expansion. We anticipate that expansion into various North American, Asian, European and Middle Eastern nations will provide the next steps in global growth. We expect these plans to be released in another 3 to 6 months. We think that current expansion strategy to first offer the platform digitally, and then roll out in-store once sufficient scale and demand is achieved is a very pragmatic and risk mitigating method of market entry. Once again we iterate that the in-store rollouts will provide the most upside in the mid-term.

Products
We have made a suggestion for a new expansion to Afterpay's core product that has been positively received by the management team. We are not privy to whether the idea will be pursued, but it has the potential to massively increase their addressable market by a factor of 4-8 times from our analysis, cut credit risk drastically, while being able to be deployed utilizing the existing merchant agreements and infrastructure; so benefiting from massive scalability at very low incremental cost. We will only disclose this information to our Fund investors on a case by case basis due to commercial sensitivities and uncertainty around whether the concept will be pursued.

Management Team
We believe the quality of Afterpay's management team is outstanding. A few attributes that we look for namely: longevity, alignment with investors and commercial acumen; are held in abundance by the key management personnel.
The model of the young, conceptual founder supported by a well recognised and experienced management team has worked well in our experience. Examples are Google where the two young co-founders were ably supported by Eric Schmidt and Ebay where Meg Whiteman supported the founder during a period of rapid growth.

We leave you with **the 6 Principles that drove Amazon's success also typified by Afterpay:**

1. Take advantage of the window of opportunity - Execute with speed and precision, before larger players can react.
2. Make decisions for the longer term - 5-7 years - For example, the rewrite of Afterpay's code base for global expansion
3. Long term market share leads to long term profits - Aim for market leadership which leads to greater capital velocity and stronger returns on capital over the long term
4. Acting with boldness in decision making - Typified by the UK market entry via the acquisition of Clearpay
5. Focus on Customer service and satisfaction - Afterpay's focus on a clear, customer-centric product; and validated by repeat customer usage in excess of 80%
6. Be the first in a large addressable market - Capitalising on a first mover advantage, in a product that is absolutely unique in the space.

Afterpay is one of our key equity investments, and we consider this a permanent holding.