AfterPay: A Q&A

We respond to some recent spurious claims put out by a fund manager with a Q&A below.

Is Afterpay similar to Zippay or other providers of consumer credit/finance?
Credit can be defined as providing funds to another party in exchange for a promise to repay the principal plus an additional agreed amount (interest) generally linked to the duration the funds are drawn or advanced.

Afterpay does not provide *complying* consumers with credit per se being a truly cost free instalment payment solution for *compliant* customers.
Note my emphasis on consumers complying with Afterpay's terms of service. Non-compliant consumers occur a fine or late fee as they accept under the terms of service.
While there have been critics of these 'fines', consumers are under no obligation to use the service if it does not suit their needs or if they find the terms of service onerous.

In summary, Afterpay is <u>free to use for compliant customers</u> in contrast to providers of consumer credit who charge interest to the customer as their core business.

Is Afterpay just a factoring business in disguise?
Afterpay is not a factoring business, but rather an innovative blend of modified supply chain finance and lay-by tailored for the mass consumer market. The table below illustrates the key differences between Afterpay and a 'vanilla' factoring business.

	Afterpay	**Factoring**
Recourse to Merchant	Represents a true sale of the merchant's receivables, so no vendor liability	Typically full recourse to the merchant for any shortfall in collecting funds from customers
Initiating party	Customer	Merchant
Eligible Transactions	Approved orders	All invoices/orders
Payment Terms	Paid over 4 equal instalments every 2 weeks. 1st payment taken at time of order	100% paid on due date
Sum financed	100% less Afterpay's fee plus commissions	Generally 80% at time of invoice. Remaining 20% minus accrued fees /interest and discount rate only paid once customer has paid invoice in full
Interest Rate	Nil - Afterpay fees and commission negotiated upfront on a per transaction basis	Typically >10% per annum
Benefits accrue to	All stakeholders: • Merchant via clean sale of receivables at pre-agreed rate • Customer via payment plan • Afterpay via fees and commissions	• Factoring company via recourse to merchant; fees/interest and discount rate

Aren't merchant fees a bit thin at 4% considering the credit risk?
The rate merchants pay for the facility is set by Afterpay. The 4% rate assumption was probably valid 12-18 months ago when Afterpay was an unknown quantity in the market. We have spoken to numerous retailers who use Afterpay; the recent commission structures in the sub-$20 million revenue business category appear to be between 6-7% plus a nominal fee per transaction. Customer satisfaction is very high with over 85% of revenue being generated by repeat customers.

This to us demonstrates the pricing power of a market leader or incumbent. We have also noted that once a merchant within a particular market segment adopts Afterpay, it's competitors follow suit fairly quickly adding to the products virality.

Afterpay as the payment intermediary captures value in a number of ways:

- monetarily via fees and commission
- information wise via its transaction and credit databases
- intangibly via building up brand awareness and recognition. Brands are more important online than they are in the physical world.

Does Afterpay lend to people who don't have a credit card?
Yes, you do not need a credit card to be eligible for Afterpay. A credit card is not necessarily evident that a consumer is credit worthy.
Credit card usage has actually been on a slight decline in terms of per capita usage in Australia. In fact less than 30% of Millennials possess a credit card in the US market. 85% of Afterpay transactions are via debit card ie. not credit card.

But what about the credit risk?
Afterpay transfers 100% of the credit risk from the merchant to itself, with genuinely no recourse for any shortfall in the case the customer does not complete their payment plan. This is attractive from a merchant perspective, and puts the onus on Afterpay to develop systems that accurately assess a consumers ability to repay the instalments.

Credit risk is mitigated by the fact that if any payments are late, new transactions are impossible; so the quality of the credit book continually improves with the number of transactions that go through the system. Afterpay relies on a mathematical principle called the Law of Large numbers. This probability theorem stipulates that as the number of occurrences (or in this case, transactions) increases, the average of the result of these transactions will be closer to the expected value. We see this principle at work commonly within the insurance industry and other industries which assess and transfer risk.

What if there is a recession, could Afterpay lose money?
We feel that in an economic downturn, it is likely thatAfterpay's utilization may increase due to attractiveness of paying off discretionary purchases via instalment plans; it is evident that customers use the product as a budgetary tool.

Afterpay can be thought of as a microfinance tool, as the average customer use is circa $200 in value, being used 5-6 times per year. Given the regular usage, relatively small amount advanced and large utility value of the service; we think that it's highly unlikely that customers would risk the loss of access to a service they use regularly.
In contrast, the average credit card debt in Australia is $4,200 and average personal debt is circa $8,000 per head; these payments can be deferred without any immediate consequences and have a differentiated risk profile when compared to Afterpay.

The potential for credit risk is actually highest at the time of a consumer's first purchase, with it falling rapidly with each subsequent purchase as users do not want to lose the utility gained by using the system.

OK, what about companies offering competing services; what are Afterpay's key differentiating factors?
Afterpay product offering is clear and vanilla to customer; with no variation in terms whatsoever, in contrast to competitors.

Competitors are at least 2 years behind Afterpay in terms of technological integration, merchant reach and services levels from both customer and merchant aspects. One only needs to possess a rudimentary knowledge of technology to know that the company with the most functional application, API and User Experience generally does best over time.

Afterpay's execution has been outstanding to date. It has successfully taken exploited its first mover advantage and scaled up to become the dominant player in the Australian market. We note that in developing segments of the market, it is typically who can take the most market share at the earliest stage that eventually survives and thrives. An example of this is Paypal, who fought off a number of competitors to emerge as the market incumbent due to its virality and success in customer acquisition.

Feedback from merchants suggests that revenue rises with the adoption of the service and it is a service that is in high demand with customers. Afterpay's merchant directory and promotion via its social network channels is a valuable form of 'free' promotion for merchants. In addition, in regards to merchant service issues are typically resolved the same day in contrast to the extended support timelines of competing products.

It is NOT in Afterpay's best interests to have customers spend beyond their means and be in arrears. This is because Afterpay earns more from recycling its capital quickly (ie. receiving customer payments and purchasing merchant receivables) than the late fees it charges to customers in arrears. <u>This is in contrast to its competitors.</u>

Why is Afterpay's revenue so low? Is this the same as gross sales?
Afterpay according to the notes in its financial statements recognises revenue as the economic capture between the gross amount and net amount paid to merchant. Gross sales they define as the total amount of receivables that they purchase off the merchants.
We consider the gross sales to be the most relevant figure in measuring growth however, both measures should be monitored.

So what makes Afterpay so compelling for you?
When analysing growth companies we look for the following key attributes:

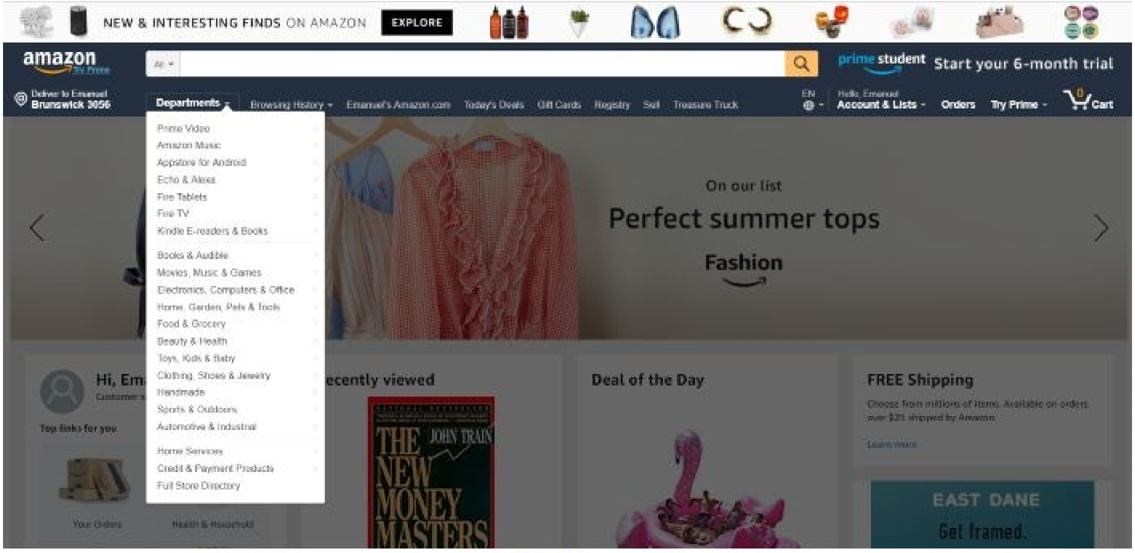
1. Growth in top line gross sales
2. Growth in operating margins
3. Balance sheet optimization and capital allocation policies
4. Potential for valuation multiple expansion
5. Network effects and oligopoly potential

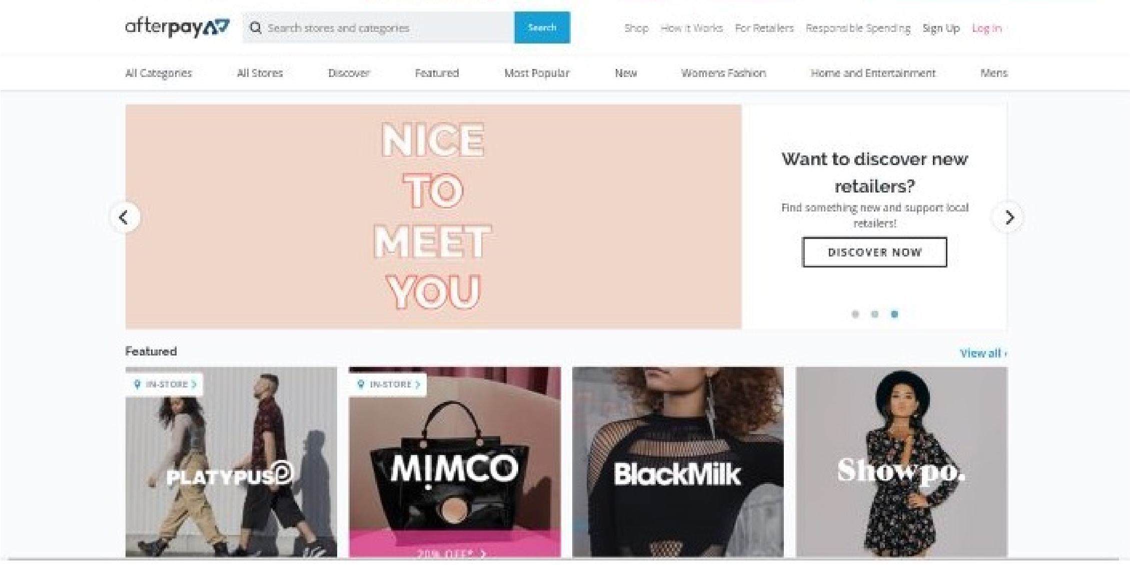
Afterpay ticks all our boxes. We have made the analogy to Amazon previously and we compare some key metrics below.

Afterpay	Jun-16	Dec-16	Jun-17	Dec-17
Gross sales	$ 34,000,000	$ 132,000,000	$ 384,000,000	$ 1,000,000,000
Users	100,000	400,000	840,000	1,500,000
Marketing spend	$ 135,000	$ 366,000	$ 114,000	$ 1,576,000
sales/user	$ 340	$ 330	$ 457	$ 667
acquisition/user	$ 1.35	$ 0.82	$ 3.86	$ 0.42
Half yearly metrics				
Gross sales growth	N/A	388%	291%	260%
User Growth	N/A	400%	210%	179%
Sales per user growth	N/A	-3%	39%	46%
Amazon	**1997**	**1998**	**1999**	**2000**
Gross sales	$ 147,800,000	$ 610,000,000	$ 1,640,000,000	$ 2,760,000,000
users	1,500,000	6,200,000	16,900,000	20,000,000
marketing spend	$ 40,486,000	$ 133,023,000	$ 413,150,000	$ 594,000,000
sales/user	$ 99	$ 98	$ 97	$ 138
acquisition/user	$ 27	$ 28	$ 39	$ 192
Annual metrics				
Gross sales growth	N/A	413%	269%	168%
User Growth	N/A	413%	273%	118%
Sales per user growth	N/A	0%	-1%	42%

Key Points:

1. Afterpay is experiencing faster top line and user growth at a far lower acquisition cost than Amazon experienced at a similar stage of growth. We note that the company have disclosed that they are achieving gross sales of $3 billion on an annualised basis; we expect this to grow materially in this half year.
2. The table demonstrates the sheer virality of Afterpay's product; it enjoys network effects from both consumer and merchant sides. This is an extremely rare attribute. We note that in the digital services space, oligopolies are the norm as opposed to the exception.
3. We note a number of non-monetary elements that are similar to Amazon namely:
   - Cultural: "what's good for customers is good for stakeholders"; market participants with the greatest scale wins by building market share quickly at the lowest relative margin.
   - Technological and service advantages: best application, website and API among competition, superior service for both customers and merchants. User Interface and Experience is similar to Amazon (see below)
   - Potential to grow into other complementary business lines: Credit reporting, online mall offering etc.





Why are you writing this?
The main purpose of this Q&A is to correct inaccurate statements put forth by a fund manager as well as to put misconceptions around Afterpay's business model to rest.

Once again this highlights the important of selecting an investment manager who possesses the necessary skills, objectivity and intellectual humility to understand and capture profits from investing in a company with an innovative business model, experiencing viral growth.

We expect Afterpay to release additional positive news regarding further growth in the coming months. We have come across information in the public domain that demonstrates the growth path ahead for Afterpay.

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

Thank you to those in our network who contributed information material to this article.

This is an extract from Datt Capital's forthcoming monthly report
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