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Afterpay Touch Group (APT)

A Winning Formula

Recommendation
Buy (unchanged)

Price
\$28.28
Target (12 months)
\$38.41 (previously \$31.76)

GICS Sector
Diversified Financials
Expected Return

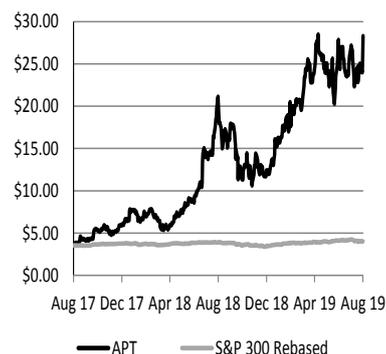
Capital growth	35.8%
Dividend yield	0.0%
Total expected return	35.8%

Company Data & Ratios

Enterprise value	\$7.0bn
Market cap	\$7.1bn
Issued capital	252.6m
Free float	84%
Avg. daily val. (52wk)	\$46m
12 month price range	\$10.36-\$28.77

Price Performance

	(1m)	(3m)	(12m)
Price (A\$)	25.93	25.08	18.55
Absolute (%)	9.06	12.76	52.45
Rel market (%)	13.60	12.47	48.22

Absolute Price


SOURCE: IRESS

Leading the Pack

APT is onto a winning formula as the key innovator in the Buy Now and Pay Later space, dominating many of the high-value consumer areas with rapid growth across its key markets. The US has passed 2m active users, the UK is off to a flying start surpassing 200,000 users within a quicker timeframe than the US when it started. ANZ closed the period at 2.8m active users, with the segment breakdown showing the division delivered EBITDA of \$87.0m, up \$43.4m vs pcp.

APT confirmed a new partnership in the US, with VISA and Afterpay to jointly pursue the development of innovative new solutions to help with user experience, efficiencies and product. The company will provide more detail when they are closer to launch, but rather than working against Afterpay, VISA has decided to collaborate instead, highlighting how important a player Afterpay is becoming in the payments space.

The FY19 result delivered underlying EBITDA of \$28.7m, vs our ~\$25.0m estimate. Our EBTDA estimate was \$14.1m, which includes the interest expense relating to the receivables book. Elsewhere in the result the key items appear to be moving in the right direction, with loss rates down, and the NTM improving. However we caution that with a changing business mix and heavy investment occurring, it is hard to forecast short-term earnings, but we remain confident in the overall trajectory of the business.

Earnings Revisions

Following APT's trading update, we have upgraded our underlying active customer estimates by between 13.5% – 26.7% over the forward estimates, while we have upgraded our underlying EPS by 7.2%, 4.2% and 8.2% for FY20, FY21 and FY22 respectively. The earnings revision is driven by higher customer growth and Total Transaction Value (TTV) estimates, and offset to a degree by higher cost estimates. We note that our CLV valuation methodology prioritises customer growth, particularly where gross margin and retention rates are healthy. Following these changes our revised Price Target is \$38.41 per share (previously \$31.76), with our Buy recommendation remaining unchanged.

Earnings Forecast

Year end June 30	2019	2020e	2021e	2022e
Sales revenue (\$m)	218.0	441.8	766.2	1166.8
EBTDA (Adjusted) (A\$m)	17.7	51.1	114.1	186.6
NPAT (reported) (A\$m)	-43.7	6.4	47.3	94.0
NPAT (adjusted) (A\$m)	3.0	36.4	77.3	124.0
EPS (adjusted and fully diluted) (cps)	1.2	13.6	29.0	46.5
EPS growth (%)	Large	Large	112.4%	60.4%
Adjusted PER (x)	2370.8	207.4	97.6	60.9
Price/CF (x)	-28.6	-575.5	67.3	63.1
EV/EBITDA (x)	393.4	136.2	61.0	37.3
Dividend (eps)	0.0	0.0	0.0	0.0
Franking (%)	na	na	na	na
Yield (%)	0.0%	0.0%	0.0%	0.0%
ROE (%)	1%	6%	11%	16%

SOURCE: BELL POTTER SECURITIES ESTIMATES

FY19 Highlights

FY19 Result Highlights

- Global underlying sales up 140% to \$5.2 billion;
- Active numbers at 5.2m as at 23 Aug, up from 4.6m at the end of FY19;
- Active merchants climbing to 32,300;
- US Active Customers currently over 2.1m;
- Stable merchant income margins at 3.9% pro forma;
- Underlying free cash flow of \$33.3m; and
- Over \$230m in cash and \$947m in undrawn receivables finance facility.

Successful UK launch

Afterpay’s success in the UK, through Clearpay, is closely following the progress of their US expansion. To put things in perspective, Clearpay reached over 200k active customers in the first 15 weeks, which is higher than the US at the same time post-launch (Figure 2). Further, an encouraging statistic from Australia is that the frequency of customer purchases goes up the longer they are on the platform (Figure 3) below.

Figure 1 - Key Afterpay Assumptions

Active Customers (m)	1H19	2H19	1H20e	2H20e	1H21e	2H21e
ANZ	2.50	2.80	3.10	3.40	3.70	4.00
US	0.70	1.80	3.10	4.50	6.00	7.50
UK	0.00	0.03	0.63	1.33	2.13	3.03
Total	3.20	4.63	6.83	9.23	11.83	14.53

Margin (%)	1H19	2H19	1H20e	2H20e	1H21e	2H21e
Merchant Fee	3.7%	3.9%	3.9%	3.9%	3.9%	3.9%
NTL	-0.6%	-0.3%	-0.5%	-0.4%	-0.5%	-0.4%
Processing and Financing	-1.1%	-1.2%	-1.3%	-1.3%	-1.3%	-1.3%
Net-margin	2.1%	2.4%	2.1%	2.3%	2.1%	2.2%

Transaction Value (\$m)	1H19	2H19	1H20e	2H20e	1H21e	2H21e
ANZ	2,009	2,305	2,804	3,110	3,712	4,052
US	264	664	1,857	2,470	4,378	4,826
UK	0	6	165	470	865	1,238
Total	2,273	2,975	4,826	6,050	8,955	10,117

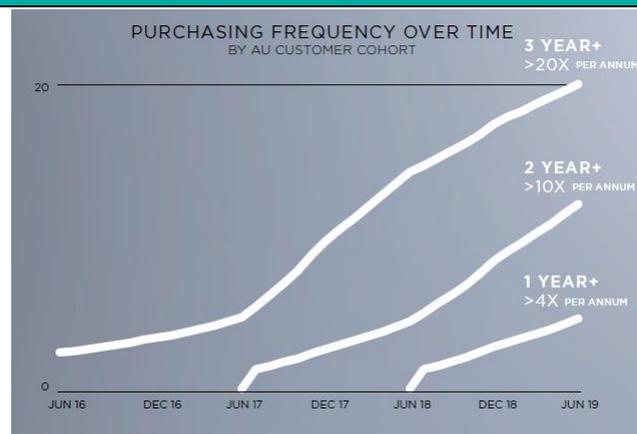
SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Figure 2 - Afterpay UK/US Initial Growth Rates



SOURCE: COMPANY DATA

Figure 3 - Purchasing Frequency Over Time



SOURCE: COMPANY DATA

Valuation and Changes

Valuation

We utilise a Sum-of-the-Parts Valuation, with the key Afterpay component relying on a Customer Lifetime Value (CLV) based methodology. The key assumptions in our valuation can be found in the table below. Our total APT valuation is \$38.41 per share (previously \$31.76), which forms the basis of our Price Target, and is supportive of our Buy recommendation on the stock.

Figure 2 - Valuation

Sum-of-Parts Valuation

Afterpay Customer Lifetime Value based methodology	
Discount rate (%)	10.1%
Retention rate estimate (%)	85%
Weighted three year customer numbers*	7,725,000
Customer annual spend (\$0.00)	1,580
Gross margin (%)	2.21%
Afterpay CLV based valuation (\$m)	12,465
Net-cash (\$m)	231
Pay Now valuation	123
Corporate	-769
Total APT value (\$m)	12,050
Fully diluted share count (m)	267
Valuation per share pre AUSTRAC discount (\$0.00)	45.18
AUSTRAC Audit -15% Discount	-6.78
Adjusted APT Valuation per share (\$0.00)	38.41

* (50% weighting to Year 0, 35% to Y1e, and 15% to Y2e)

SOURCE: BELL POTTER SECURITIES ESTIMATES

Customer numbers and earnings revisions

Following APT's trading update, we have upgraded our underlying active customer estimates by between 13.5% – 26.7% over the forward estimates, while we have upgraded our underlying EPS by 7.2%, 4.2% and 8.2% for FY20, FY21 and FY22 respectively. The earnings revision is driven by higher customer growth and Total Transaction Value (TTV) estimates, and offset to a degree by higher cost estimates. We note that our CLV valuation methodology prioritises customer growth, particularly where gross margin and retention rates are healthy. Following these changes our revised Price Target is \$38.41 per share (previously \$31.76), with our Buy recommendation remaining unchanged.

Figure 3 - Earnings revisions

Earnings Revisions	FY20e (new)	FY20e (previous)	Change (%)	FY21e (new)	FY21e (previous)	Change (%)	FY22e (new)	FY22e (previous)	Change (%)
Customer numbers	9,230,000	8,130,000	13.5%	14,530,000	11,930,000	21.8%	19,930,000	15,730,000	26.7%
EPS (Cash) (cps)	13.6	12.7	7.2%	29.0	27.8	4.2%	46.5	43.0	8.2%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Interim earnings

Figure 4 - Interim earnings

INTERIM INCOME STATEMENT													
Y/e June 30 (\$m)	2018	1H19	2H19	2019	1H20e	2H20e	2020e	1H21e	2H21e	2021e	1H22e	2H22e	2022e
Total operating revenue	113.9	94.1	123.9	218.0	196.6	245.2	441.8	359.7	406.5	766.2	565.5	601.3	1166.8
Net-transaction loss	-9.2	-13.6	-8.6	-22.2	-25.6	-21.2	-46.7	-47.4	-35.4	-82.8	-74.8	-52.5	-127.3
Total other variable transaction costs	6.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Operating expenses	42.7	47.7	64.4	112.1	88.9	111.9	200.8	143.6	167.3	310.9	208.6	236.8	445.4
Adjusted EBTDA	27.7	3.8	13.9	17.7	19.1	32.0	51.1	48.6	65.4	114.1	85.7	100.9	186.6
Depreciation	1.8	0.9	1.1	2.0	0.9	0.9	1.7	0.9	0.9	1.7	0.9	0.9	1.7
Amortisation	9.0	5.9	5.9	11.7	6.5	6.5	13.0	7.0	7.0	14.0	7.5	7.5	15.0
EBT	16.8	-2.9	6.9	4.0	11.8	24.6	36.4	40.8	57.6	98.3	77.3	92.5	169.9
Operating income tax expense	1.4	0.7	0.3	1.0	0.0	0.0	0.0	5.5	15.5	21.0	20.9	25.0	45.9
Underlying NPAT	15.5	-3.6	6.6	3.0	11.8	24.6	36.4	35.3	42.0	77.3	56.5	67.5	124.0
Share based payments & Acq. Amort.	22.9	22.5	16.8	39.2	15.0	15.0	30.0	15.0	15.0	30.0	15.0	15.0	30.0
Significant items (pre-tax)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Significant tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Significant items (after tax)	-1.0	3.8	-11.3	-7.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
R&D grant	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reported profit (A\$m)	-9.0	-22.2	-21.5	-43.7	-3.2	9.6	6.4	20.3	27.0	47.3	41.5	52.5	94.0
Loan receivables													
Y/e June 30 (\$m)	2018	1H19	2H19	2019	1H20e	2H20e	2020e	1H21e	2H21e	2021e	1H22e	2H22e	2022e
Gross loan receivables	274.5	380.5	452.7	452.7	856.7	1089.0	1089.0	1656.7	1922.2	1922.2	2683.7	2848.6	2848.6
Closing provisions for bad debts	15.0	28.2	0.0	0.0	48.3	60.5	60.5	89.5	101.2	101.2	141.2	149.9	149.9
Net customer loan receivables	259.5	352.4	452.7	452.7	808.4	1028.5	1028.5	1567.1	1821.0	1821.0	2542.5	2698.7	2698.7
Afterpay estimates													
Y/e June 30 (\$m)	2018	1H19	2H19	2019	1H20e	2H20e	2020e	1H21e	2H21e	2021e	1H22e	2H22e	2022e
Merchant fee revenue (\$m)	88.3	85.2	115.7	200.9	188.2	236.6	424.8	351.0	397.6	748.6	556.5	592.2	1148.7
Processing and Financing cost (\$m)	17.6	24.8	34.5	59.3	60.3	77.4	137.8	117.3	135.6	252.9	193.5	208.4	401.9
Gross Profit (\$m)	70.7	60.3	81.3	141.6	127.9	159.1	287.0	233.7	262.0	495.7	363.0	383.8	746.8
EBTDA	34.9	17.6	30.3	47.9	48.6	74.3	122.9	102.1	132.3	234.4	172.0	204.7	376.7
Buy Now estimates													
Y/e June 30 (\$m)	2018	1H19	2H19	2019	1H20e	2H20e	2020e	1H21e	2H21e	2021e	1H22e	2H22e	2022e
Revenue	25.6	8.9	8.2	17.1	8.4	8.6	17.0	8.7	8.9	17.6	9.0	9.1	18.1
Cost of sales	10.6	4.1	2.6	6.7	2.6	2.7	5.3	2.7	2.8	5.5	2.8	2.8	5.6
Net-revenue	15.0	4.8	5.6	10.4	5.7	5.9	11.7	6.0	6.1	12.1	6.2	6.3	12.5
EBTDA, Adj	7.2	2.5	2.4	4.9	2.5	2.7	5.2	2.7	2.7	5.4	2.8	2.8	5.6
Corporate Estimates													
Y/e June 30 (\$m)	2018	1H19	2H19	2019	1H20e	2H20e	2020e	1H21e	2H21e	2021e	1H22e	2H22e	2022e
Total underlying corporate expenses (\$m)	14.5	16.3	18.9	35.1	32.0	44.9	76.9	56.2	69.6	125.7	89.0	106.6	195.6

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Company description

Afterpay Touch Group (APT) is an emerging financial technology company that enables retail merchants to offer customers the ability to buy goods and services on a simple instalment plan with an easy and non-invasive application process, and at no additional cost to the end-customer. It is the combined entity of Afterpay (AFY), which was founded in February 2014 by Anthony Eisen and Nicholas Molnar. And Touchcorp (TCH) the company that developed the payment technology.

Risks to investment thesis

Key risks for the stock include although are not limited to:

- **Merger/Integration risk** - Following the completion of the AFY/TCH merger, the combined group may fail to achieve the anticipated benefits, or may incur unforeseen costs in connection with the integration of both businesses which may have a material impact on the group's earnings;
- **Credit risk** – APT extends credit to end-customers via its receivables book for which the merchants pay a fee. While this is not a traditional lending model, the company is still exposed to the risk of default or a loss of principle. Therefore, the ability of APT's technology to adequately prevent and recover bad debt is crucial to the company's ongoing viability;
- **Funding risk** – APT currently funds its loan book through a combination of equity and debt, having now secured a debt financing agreement. APT's growth may be limited if it is unable to expand its receivables book through securing further increases in debt financing facilities or raise additional equity;
- **Key person risk** – Similar to other small capitalised stocks, the loss of any key personnel may be detrimental to APT;
- **Competition risk** – APT has first mover advantage offering reverse lay-by within Australia, however there is significant risk of new entrants and increased competition, particularly from established foreign companies;
- **Technology risk** – APTs algorithms assess an end-clients repayment capabilities and the risk of fraud automatically and in real-time. APT relies on its technology to process transactions and store client data. Any failure or breach of the technology could result in an interruption of service, or the loss/theft of private data and information;
- **Regulation & licensing risk** – While APT does not currently require an Australian Credit Licence (ACL), it is still subject to a range of legal and regulatory requirements. Any changes to regulations, policies, or laws could adversely impact the efficacy of AFY's business model;
- **Fraud risk** – APT guarantees payment to merchants and is therefore exposed to the risk of fraudulent end-customers. Failures in APT's algorithms to prevent fraud would adversely affect APT's performance;
- **Market risk** – A prolonged recession, economic crisis/shock, or other factors that may lead to a sustained weak market environment have the ability to increase the levels of defaults and adversely affect the earnings potential of the company. In addition, being a listed stock, the share price may be subject to volatility and fluctuations in price; and
- **Operational risk** – The operation APT relies on internal policies and technologies in relation to lending practices and anti-fraud. Any failure in internal controls could be harmful to AFY's performance.

Table 1 - Financial summary

Afterpay Touch Group (APT)						Price Target (A\$)	38.41	Share Price (A\$)	28.28		
						Recommendation:	Buy	Market Cap (A\$m)	7,144.5		
INCOME STATEMENT						VALUATION DATA					
Y/e June 30 (\$m)	2018	2019	2020e	2021e	2022e	Y/e June 30 (\$m)	2018	2019	2020e	2021e	2022e
Total operating revenue	113.9	218.0	441.8	766.2	1,166.8	Adjusted NPAT (\$m)	15.5	3.0	36.4	77.3	124.0
Cost of sales	28.2	66.0	143.1	258.3	407.5	Adjusted EPS (fully diluted) (c)	6.9	1.2	13.6	29.0	46.5
Gross profit	85.7	152.0	298.7	507.9	759.3	EPS growth (%)	large	large	large	112%	60%
Net-transaction loss	-9.2	-22.2	-46.7	-82.8	-127.3	Diluted adjusted P/E ratio (x)	411.0	2370.8	207.4	97.6	60.9
Other variables	6.1 changed reporting					CFPS (c)	-54.3	-98.8	-4.9	42.0	44.8
Operating expenses	42.7	112.1	200.8	310.9	445.4	Price/CF (x)	-52.1	-28.6	-575.5	67.3	63.1
Adjusted EBTDA	27.7	17.7	51.1	114.1	186.6	DPS (c)	0.0	0.0	0.0	0.0	0.0
Depreciation	1.8	2.0	1.7	1.7	1.7	Yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%
Amortisation	9.0	11.7	13.0	14.0	15.0	Franking (%)	na	na	na	na	na
EBT	16.8	4.0	36.4	98.3	169.9	EV/EBITDA (x)	251.8	393.4	136.2	61.0	37.3
Operating income tax expense/(benefit)	1.4	1.0	0.0	21.0	45.9	Price/book (x)	34.6	11.0	11.5	10.7	9.4
Underlying NPAT	15.5	3.0	36.4	77.3	124.0	NTA/share (\$)	0.82	2.58	2.47	2.65	3.00
Share based payments & Acq. Amort.	22.9	39.2	30.0	30.0	30.0	PROFITABILITY RATIOS					
Significant items (pre-tax)	0.0	0.0	0.0	0.0	0.0	Y/e June 30 (\$m)	2018	2019	2020e	2021e	2022e
Significant tax	0.0	0.0	0.0	0.0	0.0	EBIT/sales (%)	14.8%	1.8%	8.2%	12.8%	14.6%
Significant items (after tax)	-1.0	-7.5	0.0	0.0	0.0	Return on assets (%)	4.9%	0.5%	3.2%	4.0%	4.2%
Reported profit (A\$m)	-9.0	-43.7	6.4	47.3	94.0	Return on equity (%)	9.0%	0.7%	5.6%	11.3%	16.5%
CASHFLOW						Dividend cover (x)	na	na	na	na	na
Y/e June 30 (\$m)	2018	2019	2020e	2021e	2022e	Effective tax rate (%)	8.3%	25.0%	0.0%	21.4%	27.0%
EBITDA	27.7	17.7	51.1	114.1	186.6	LIQUIDITY AND LEVERAGE RATIOS					
Change in provisions	4.4	4.6	-2.0	5.5	6.7	Y/e June 30 (\$m)	2018	2019	2020e	2021e	2022e
Working capital changes	-121.7	-233.8	-61.5	10.8	-29.6	Net debt/(cash) (\$m)	136.1	-181.2	501.3	1,270.8	2,126.1
Interest earned	0.0	0.3	0.0	0.0	0.0	Net debt/(cash) (ex SPV)*	-25.5	-230.9	-184.7	-248.4	-319.5
Tax paid	0.1	-0.3	0.0	-21.0	-45.9	Net debt/equity (%)	74.1%	-27.9%	76.1%	179.9%	265.7%
Associated company dividends	0.0	0.0	0.0	0.0	0.0	Current ratio (x)	259.0	575.9	1,222.8	2,104.0	3,125.2
Other operating items	-23.5	-21.8	0.0	0.0	0.0	Underlying EBITDA*					
Operating cash flow	-113.1	-233.3	-12.4	109.4	117.9	2018	2019	2020e	2021e	2022e	
Stay in business capex	-2.5	-1.7	-1.7	-1.7	-1.7	Afterpay EBITDA	34.9	47.9	122.9	234.4	376.7
Growth capex & acquisitions	-15.8	-15.7	-13.0	-14.0	-15.0	Buy Now EBITDA	7.2	4.9	5.2	5.4	5.6
Disposals	-5.1	0.7	0.0	0.0	0.0	W/A shares on issue	208.2	236.0	252.8	260.5	263.0
Investing cashflow	-23.3	-16.7	-14.7	-15.7	-16.7						
Dividends	0.0	0.0	0.0	0.0	0.0						
Other investing items	0.0	4.0	-30.0	-30.0	-30.0						
Share issues/(buy backs)	1.6	461.5	0.0	0.0	0.0						
Other	142.6	96.9	0.0	0.0	0.0						
Financing cash flow	144.2	562.4	-30.0	-30.0	-30.0						
Increase in cash/(debt)	7.8	312.4	-57.2	63.7	71.1						
Cash at end of period	25.5	231.5	185.3	248.9	320.1						
BALANCE SHEET											
Y/e June 30 (\$m)	2018	2019	2020e	2021e	2022e						
Cash	25.5	231.5	185.3	248.9	320.1						
Loan receivables	239.1	452.7	1089.0	1922.2	2848.6						
Other receivables	17.3	3.0	5.9	9.9	60.1						
PPE	4.0	4.2	4.2	4.2	4.2						
Intangibles	48.9	49.3	49.3	49.3	49.3						
Other	57.5	70.7	131.2	171.9	220.6						
Total assets	392.2	820.5	1474.0	2415.5	3512.0						
Payables	42.9	110.0	111.9	167.3	236.8						
Funding facilities	161.6	50.2	686.5	1519.7	2446.1						
Interest bearing liabilities ex SPV	0.0	0.6	0.6	0.6	0.6						
Provisions	2.3	3.5	8.4	14.0	20.7						
Other	1.9	6.4	6.4	6.4	6.4						
Total liabilities	208.7	172.0	815.1	1709.3	2711.8						
Contributed equity	192.6	677.7	681.7	681.7	681.7						
Total shareholders funds	183.6	648.5	658.9	706.2	800.2						

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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Lafitani Sotiriou, authoring analyst, holds long positions in APT

Disclosure: Bell Potter Securities acted as co-manager of the \$117m August 2018 placement, and participated in the June 2019 \$317m placement and \$100m sell down and received fees for that service.

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