Contact Asset Management

INSIGHTS

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ASSET MANAGEMENT

Afterpay . . . now an afterthought

Afterpay ("APT") - the Buy Now Pay Later juggernaut has been one of the best performing stocks of the past year and is now a Top 20 ASX listed company rather than a Mid-Cap. We've never owned it, and despite the negative impact on our relative performance, we are comfortable with that decision. This Contact Insights piece explains why.

Welcome to the latest edition of Contact Insights. We have created these short pieces in recent months to complement our Quarterly Reports that we have been writing for over seven years. We believe that direct communication with our co-investors is important as it encourages transparency and allows us to explain our investment strategy and performance.

We seeded the Contact Australian Ex-50 Fund on 17th March 2020 amid the rout in global markets stemming from the uncertainty of COVID-19. Since then, the Fund has delivered 24.3% return after all fees – a more than pleasing outcome. However, when we compare the short-term performance to our benchmark, the S&P/ASX Midcap 50 Accumulation Index, our relative performance lags significantly. There are two primary reasons for this. Firstly, we seeded the Fund with our own capital and took a cautious approach in the early months amid significant uncertainly, holding over 30% of the Fund's assets in cash. We protected capital but did miss the beginning of a significant rally, particularly in April 2020, when the S&P/ASX Mid-Cap Index shot up by over 16% for the month. The second reason for our relative underperformance can be summed up in a single word – Afterpay.

Since mid-March 2020 to January 2021, the APT share price moved from $19 to $150. Of note, it bottomed at $8.90 on 23 March 2020. Its weighting in the S&P/ASX Midcap 50 Index climbed from 1.61% to 8.65%. The detraction from the Fund's performance from having a zero exposure to APT has been 9.1%. It is rare to have a single stock detract from performance to such an extent – particularly when the stock is not owned.

This is not intended to be a deep dive into the APT business model, the regulatory environment or funding structure. Nor it is intended to criticize – we admire the success achieved to date by the founders of Afterpay. The intention here is to explain why APT never suited our Fund.

Contact's Investment Approach

Contact is owned by its founders Tom Millner and Will Culbert, alongside its staff and partner Washington H Soul Pattinson & Co Limited ("Soul Patts"). Soul Patts is one of Australia's oldest and most respected investment houses. The approach we adopt in long-term investing has been honed for generations.

Our investment approach is premised on the belief that achieving good returns in stocks requires keeping a long-term focus and a disciplined investment strategy. Our strategy is built on five fundamental pillars: Principal Activity, Income, Financial Strength, Management and Valuation.

This process, which we adopt with diligence and discipline, is the bedrock of our stock selection process and will form the foundations of the APT discussion.

Principal Activity

APT was founded in 2014. It is a leading player in the fast-emerging Buy Now Pay Later (BNPL) instalments market. The core BNPL offering allows consumers to pay off purchases over 4 x fortnightly instalments with no interest with account limits up to $1,500/$2,000. Afterpay is seeing rapid adoption from mostly younger demographics, that are increasingly averse to traditional credit products. Consumers get the cashflow and budgeting benefit of deferring retail payments over 6-8 weeks.

APT generates revenue by charging the merchant between 3-6% of the transaction value. The only customer-generated revenue comes from late-fees (said to be ~17%). The Merchants are happy as APT provides a positive impact on sales (i.e. new customers, increased conversion rates) and APT takes on all chargeback risks (e.g. fraud, credit).

From an industry structure perspective, we note that while APT has a clear first mover advantage, we consider barriers to entry and switching costs to be low as BNPL operators rarely hold exclusive relationships with either Consumers or Merchants. As noted above, while we do not intend to conduct a deep dive into the regulatory environment, we do note that regulatory risk is an ongoing issue.

In all, APT's evolution has been stellar. Future success is now premised on global growth, which is expected to face greater competition and margin pressure – this has been the early experience in the United States. We have no major qualms with the revenue model. However, APT is yet to make a profit. We do not invest in loss making companies. We dig deeper on the accounts in Financial Strength below.

Income

We invest in companies that offer us an income stream. This is important as dividends have historically provided a significant portion of the total return on equities. For example, over the past twenty years to 31 December 2020, the S&P/ASX 300 Accumulation Index returned 8.1% per annum. Of that, 55%, or 4.4% p.a., has been delivered through dividends.

When assessing potential investments, we look for a combination of Quality, Growth and Income in the companies that make up our Funds. If a company does not pay a dividend and has no prospects of paying a dividend in the next two years, then we pass.

Why do we consider dividends to be so important? As Geraldine Weiss frankly states, "dividends don't lie". For a company to pay a dividend, it must have the money to pay it with. Earnings can't be some accounting sleight of hand. They must actually be there, in cash. Paying a dividend proves to us that the business model works.

APT has never paid a dividend and is unlikely to do so for many years. We understand that as APT's focus is on pursuing growth. But the bottom line is, it is hard to pay a dividend when there are no earnings.

Financial Strength

Our fundamental problem with APT is that it doesn't make any money.

When we assess the Balance Sheet and Cash Flow, we are concerned with the way that APT finances its operations. Cash flow is the survival feature of any business and APT is burning a lot of it.

Since listing, APT has delivered cumulative losses of $560 million in Operating Cash Flow. Without positive operating cash flow, businesses are eventually forced to either increase debt or raise equity. APT has been doing both. This may be sustainable in the short-term but detrimental longer-term.

On the debt side, APT had $465 million in long-term debt as at 30 June 2020, up from $50 million a year earlier. Equity raisings are keeping the business afloat. In the past four years, APT has issued almost $800 million in new shares and options. There has been a 90% increase in shares on issue in only 4 years! There has also been 46 million options issued which creates additional dilution.

Based on a recent Macquarie Research piece (*Afterpay – Losing the battle to win the war, 2 February 2021*), the sell-side expects the equity raisings to continue. Macquarie is forecasting that APT will issue over $1 billion in equity and raise over $930 million in debt to fund the business growth in the next three years, which appears to be largely working capital. Macquarie's estimate of Return on Equity in fiscal year 2023 is only 4.7% - quite underwhelming in our view.

Management

As noted above, we admire what co-founders Nick Molnar and Anthony Eisen have created. Both continue to have a significant amount of wealth in APT stock through holdings of 19.9 million shares apiece.

However, they have been selling. In 2016, the duo owned 15% of the company each; they now own 7%. We consider insider selling to be a red flag. When senior management sell, it can be an insight into a reduction in confidence in the business and its outlook.

We consider it concerning that the founders are willing to be diluted rather than participate in equity raisings. As noted in the Financial Strength section above, we anticipate that APT will need to continue to tap investors for funds. As such, the alignment of the founders is likely to dilute further.

Valuation

Valuation is a contentious topic with APT. Many brokers and asset managers justify the APT valuation on a Price-to-Sales metric. We struggle to understand why any investor with a long-term, quality tilt would use this metric. It fails to incorporate profit margins, growth rates or the Balance Sheet. We believe that if a company has very high sales but never earns a cent, then it is unlikely to be a good long-term investment.

On a more traditional Price-to-Earnings multiple, the APT valuation is in nosebleed territory. Based on the abovementioned Macquarie Research piece, APT trades on a FY23 P/E multiple of 405x. This assumes EBITDA increases by 597% in three years. Highlighting how difficult forecasting APT earnings is, the same note saw the broker downgrade its FY21e profit forecasts by 140%.

At Contact, we prefer to value companies using a traditional Discounted Cash Flow (DCF) basis. In doing so, we estimate a company's future cash flows. Then we use these cash flows to calculate a fair price to pay for the company.

Often, it is interesting to invert and use a Reverse DCF. We start with the current market price of the company and then we figure out what future cash flows would justify this market price. In doing so, the reverse DCF analysis tells us where expectations are regarding the growth in Earnings per Share (EPS) into perpetuity. As an example, based on current consensus numbers of other Top 20 companies (of which APT is now one), a reverse DCF is telling us that the market anticipates that Commonwealth Bank will grow at 5%, Woolworths will grow at 4% and Telstra will grow at 2% per annum. For APT, a Reverse DCF of the current share price (at $150) implies that the company will increase its cash flows at a Compound Annual Growth Rate (CAGR) of 56% into perpetuity! It is rare to see this much blue sky in a valuation.

Conclusion

Contact's investment philosophy and process is built on five fundamental pillars: Principal Activity, Income, Financial Strength, Management and Valuation. We seek to invest in quality companies that are well managed, profitable and offer us a dividend stream. Unfortunately, APT failed for us on three key points – it is unprofitable, there is no prospect of a dividend and excessive valuation. As such, it was never for us.

For those who bought at $8.90 in March and have held on, we take our hats off to you. We have no regrets. We are not trying to be all things to all people. We remain disciplined, patient and firm believers that the opportunities never cease and we are here for the long-term. APT is now a Top 20 ASX stock and no longer in the investible universe for the Contact Australian Ex-50 Fund. As such for us, Afterpay is now an afterthought.

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