Squaring Up – the Afterpay merger

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How do Australia's banks "square" off against the arrival of Big Tech?

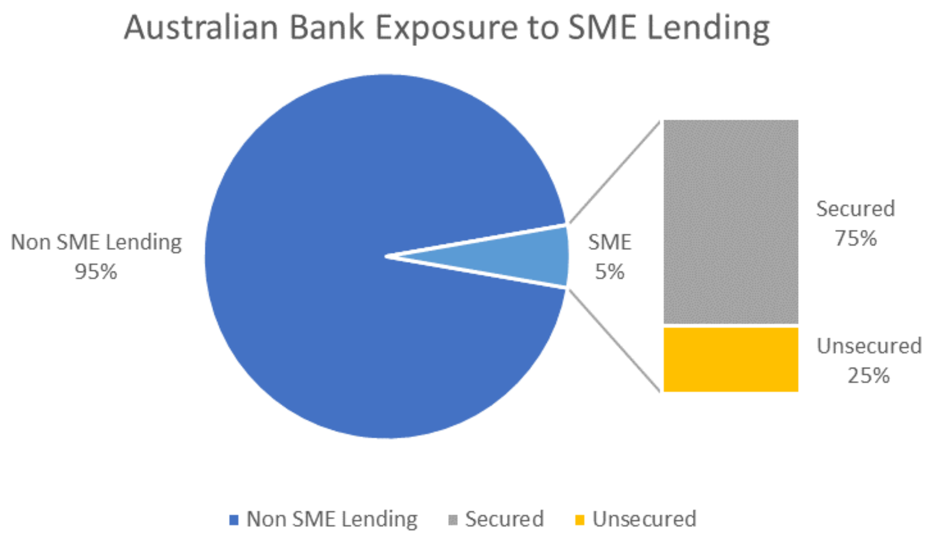
The recently announced merger between Australian buy-now-pay-later pioneer, Afterpay (APT), and US fintech giant, Square, stands to potentially change the future shape of the Australian financial services landscape. In particular, the Afterpay / Square combination has the potential to make significant inroads to the revenues and market shares of Australia's major banks in the payments and small to medium enterprise (SME) segments of the market. This article contends that diversification from holding only big banks may be a good idea given the impending disruption highlighted in this paper.

SMEs are a small portion of Australian bank lending, but provide banks with cheap funding

Australia's banks are the dominant players in mortgage lending, and have seen off countless challengers, from foreign banks' entry during the Keating era, to the more recent rise of web-based lenders such as Athena. However, we see a credible threat looming to an area of bank lending that is not well understood – lending to SMEs.

Antares Equities' analysis of the disclosures provided by the four major Australian banks suggests they loan around $165b to small business. Of this, only 25% is unsecured, while 75% is secured by mortgage. In other words, $121b is effectively mortgage lending to small and medium enterprises.

Figure 1: The majority of SME lending is secured by mortgages



Source: Company reports, Antares estimates; September 2021

While SMEs account for only 5% of the banks' total loan book, it is significantly more profitable as the rates charged are higher than those for standard owner occupier home loans, despite the underlying security of the home itself.

Why does this matter? Historically the only way for a small business to get bank funding has been to mortgage the family home. Cashflow lending is very rare, with banks citing high administrative costs associated with lending small amounts. That's where the APT / Square tie up comes in – but more on that shortly.

Australia's banks do not disclose fees from merchant transactions, but we understand that it is the deposit income that comes from these transactions that is most valuable. Based on ANZ's disclosure we estimate that the spreads earned from SME deposits over wholesale markets account for an incremental $1.2b of earnings across the four major banks. In other words, payments held from small businesses reduce the banks' cost of funding and therefore improve their profitability.

Figure 2: Estimates of the Australian banking sector's incremental profitability from SME deposits

Antares estimates of SME deposit profitability	
Small business deposits (ANZ)	$55b
Assumed market share (ANZ)	25%
Australian bank SME deposits	$220b
SME deposit rate	0.175%
Wholesale market rate	0.700%
Difference	0.525%
Incremental profits from SME deposits	**$1.16b**

Source: ANZ company reports, Antares Equities estimates; September 2021

In summary, the major banks generate an estimated 5% of their mortgage books from financing small to medium sized enterprises, typically at higher rates. Further, we estimate that by providing all the merchant services to these same companies, the system saves around $1.2b in interest costs before tax – which equates to 5% of total profits across the four major banks. We regard this as significant, given the relative maturity of the four major banks limits their ability to grow above GDP. Opportunities to grow through overseas expansion are also limited given shareholder pushback, historical mistakes in offshore investments by Australian banks, and the increasingly difficult regulatory environment in overseas banking markets.

The opportunity for disruption in SME lending

So how does this relate to the tie up between Afterpay and Square?

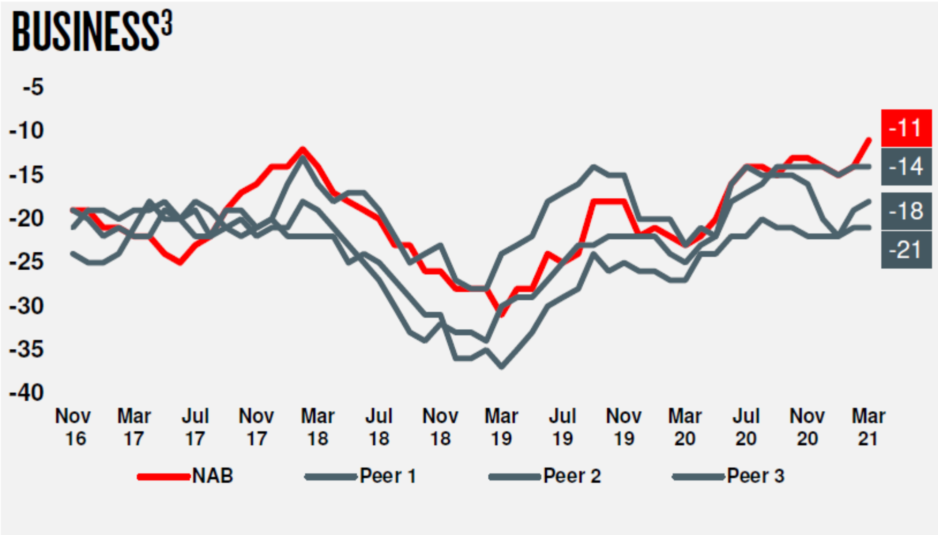
We suggest that these SME related earnings – be they interest earned or interest saved from a lower cost of funding - are now at risk given the unique and compelling proposition offered by the Square and Afterpay combination. This opportunity, in our view, has arisen because the major banks have lacked innovation and focus when it comes to supporting small businesses in Australia.

Over twenty years ago, this author took a job in a major bank's merchant services division. The role was to answer the calls of disgruntled small business owners wondering why they were waiting weeks and months for the delivery of the small merchant terminal that would allow them to accept EFTPOS and credit card payments electronically. The strange thing is that those same terminals remain the dominant transaction medium in retail Australia to this day.

The primary financing assistance provided by banks is via mortgage while the payment terminals use thirty-year-old technology which is attached to aging technology infrastructure. This means the data collected is often caught in banks' archaic systems, and is not easily accessible, therefore lacking the ability to provide real-time value to the dynamic needs of business.

The following chart from NAB details the "net promoter score" of Australia four major banks as assessed by their business customers. A net promoter score measures the difference between customers willing to recommend a service less those customers who would caution using that same service. As can be seen in Figure 3, the four major banks appear to have deeply unsatisfied business customers.

Figure 3: Business customer satisfaction with the four major Australian banks
Net promoter scores



Source: NAB; May 2021

Enter: Afterpay + Square into the SME landscape

Let's looks at each aspect of the tie up in isolation before assessing the combined outcomes. We know that Afterpay provides "buy now pay later" services to merchants. It has quickly become ubiquitous in Australia – to the point of being a verb: "why don't you *Afterpay* it?" But the offering is far more nuanced than this for the merchants – Afterpay is also a major source of lead referrals to online retailers. This is a key driver of its flywheel effect* which has enabled Afterpay's strong growth momentum. Our research indicates that Afterpay is the second largest source of online leads after Google for Australian merchants for the categories in which it operates. Afterpay is simple for a merchant to use with very little change to payments infrastructure required. Hence it can be onboarded quickly and its results assessed almost instantly.

***Flywheel effect:** The flywheel effect is a concept described by author Jim Collins in his book "Good to Great", 2001, HarperCollins, New York. It describes a process most successfully archetyped by Amazon in driving compounding growth, achieved through the momentum created by synergies between individual parts of business models that work together to keep the "flywheel" spinning. Ultimately this momentum drives accelerated and compounding growth.

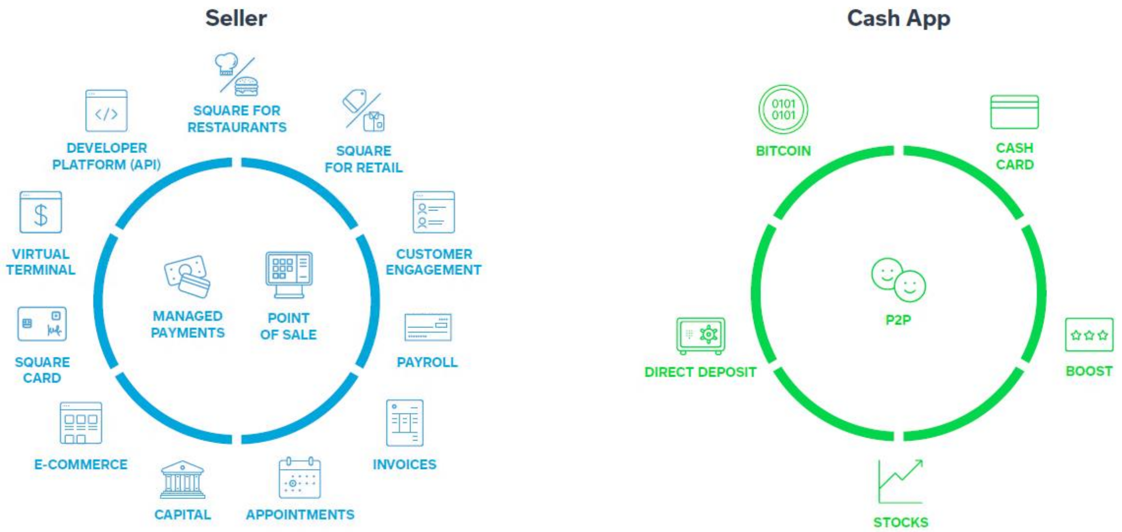
Square provides two service platforms – the Cash App which is a peer-to-peer payments system with rich functionality for consumers; and the Seller suite of products for merchants. Square's businesses have been developed mostly in isolation, with both enjoying flywheel effects that have enabled accelerating and rapid growth.

Square: Seller & Cash App 101

Seller is Square's ecosystem for merchants which encompasses a suite of products that helps sellers start, run and grow their businesses. It is functionality rich with over 30 software, hardware, and financial services products in the ecosystem. In addition to the terminals and registers Square is best known for, this suite of products enables sellers to accept payments via several channels, manage business expenses and administration centrally, and gain access to business loans through Square Loans (formerly Square Capital).

Cash App is a financial tool that allows consumers to store, send, receive, spend and invest money. Consumers can send and receive peer-to-peer payments, make purchases with prepaid cards linked to balances stored within Cash App, receive discounts and rewards at merchants (Boost), as well as trade bitcoin and stocks. Most recently, Square has also added new functionality that enables consumers to file their tax returns via the mobile app free of charge.

Figure 4: Square's two ecosystems: Seller & Cash App

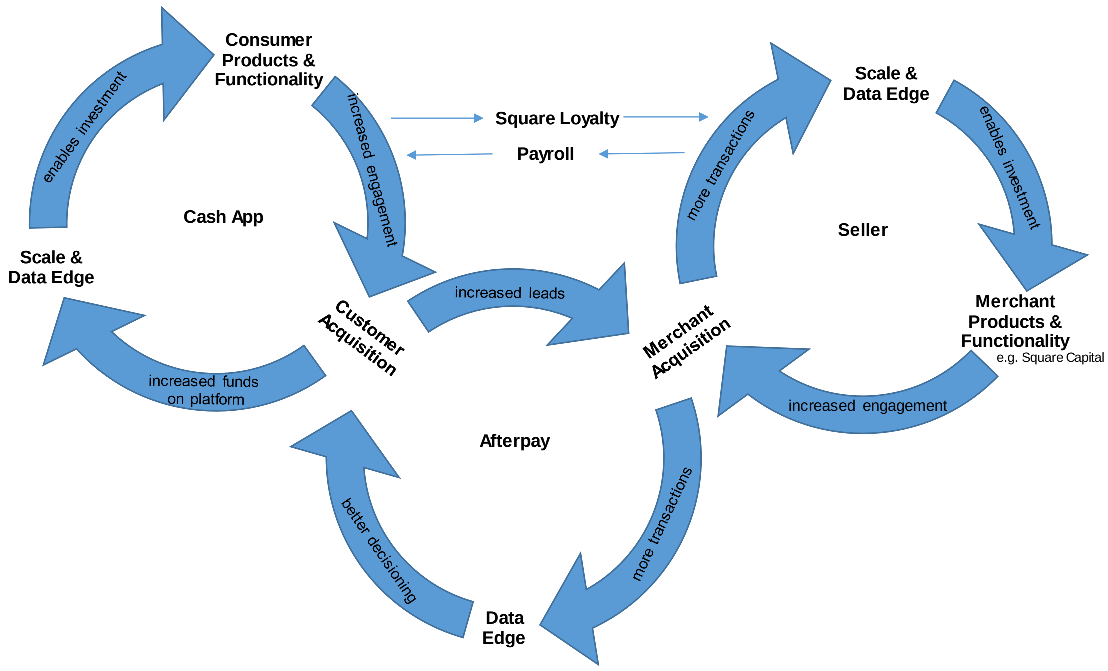


Source: Square Investor Presentation; March 2020.

A key question for Square has been how its two ecosystems might become more synergistic with one another. Until recently most Cash App consumers have had limited interaction with Square Seller businesses. Square Loyalty and Payroll have been examples of Square's attempt to bring these two platforms together. Square has more recently announced that its sellers can now accept contactless payments through cash app both in person and online. In this context, Afterpay is an ideal strategic fit into the Square model as it provides a direct link between merchants and consumers – and this is where the story becomes interesting for SMEs and Australia's four major banks.

Figure 5 depicts Antares' view of the combined Afterpay-Square business model. Individually, these platforms all employ powerful flywheel economics that have enabled their rapid, compounding growth. However, when combined, the intersection of customer acquisition and merchant acquisition between Afterpay and Square's Cash App and Seller ecosystems will potentially see momentum accelerate further across the combined businesses.

Figure 5: Combined triple flywheel from combining Afterpay and Square ecosystems



Source: Antares Equities; September 2021

Square + Afterpay positioned to introduce innovation into an industry that has lacked it

Square already has a presence with a number of SMEs in Australia through its Seller suite of products, which seems to attract favourable anecdotal feedback. Afterpay has over 50,000 merchants on its local platform which represents one-third of all Australian retail merchants. We believe many of these merchants will be within reach of Square post the tie-up with Afterpay. Afterpay has succeeded because it adds value for merchants that use it. Its combination with Square's Seller business will provide a solid endorsement of Seller by a trusted partner and introduce a new suite of value adding products to them. As such, we expect that many Afterpay merchants will adopt Square's services.

Square's Seller business provides numerous services which are not offered by traditional EFTPOS terminals from the four major banks. Traditional terminals are reported to have frequent outages which are disruptive to businesses - a signal of underinvestment. Further, the major banks have not invested in the necessary technology to leverage the data the terminals could provide.

In contrast, Square's Seller service links the point-of-sale terminal to inventory and payroll components that provide merchants with live, up-to-date reports. This is possible because all transactions are loaded directly into the cloud, making the data easy to access in real-time. Square provides such services for approximately 2.2m Seller customers in the US who are mostly SMEs. Customers can use these reports to compare trends to previous outcomes as well as to peers and thus understand future cashflow and inventory requirements.

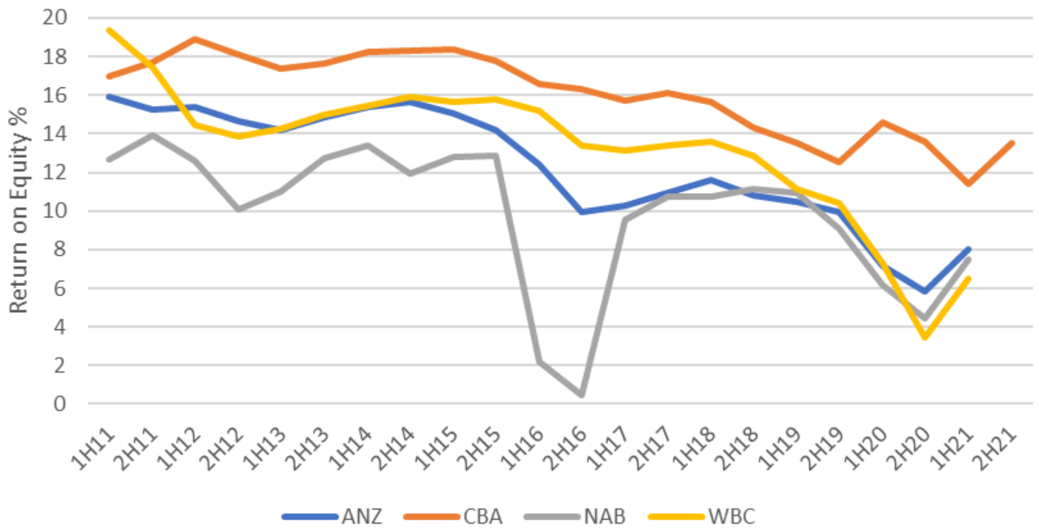
In addition, Square's SME customers can use the system to apply for finance when required. Square Loans (formerly Square Capital), which forms part of the Square Seller suite of products, can download the same transaction data quickly and rapidly from the cloud. Subject it to its lending algorithms, Square can then offer instant and seamless finance to merchants if requested. Our research suggests that this has already been happening in Australia.

The problem with the four major banks in Australia

The recommendations of Australian small business owners that use Square are glowing. Ease of use and access to data and finance are more and more critical to smaller businesses, however in our view this has been largely ignored by the four major banks. Instead, they have preferred the safety and returns of mortgage financing, which is a perfectly rational judgement in the absence of real competition and a market structure that is supported by the government's "four pillars" policy.

. This has underpinned world leading industry returns for many years, although these have recently come under pressure.

Figure 6: Australia's four major banks - return on equity (%)



Note: CBA is a June financial year end, ANZ, NAB and WBC are September year ends
Source: Bloomberg; August 2021

One of the key issues for the major banks has been an underinvestment in systems that has resulted in significant "tech debt". For instance, banks have had to invest heavily into compliance and other associated costs due to well publicised problems identified in the banking Royal Commission arising from their failure to provide appropriate services to their customers.

Tech debt: a concept in software development that reflects the cost of additional rework caused by patching solution upon solution instead of taking a more strategic, wholesale and long-term approach to technology.

We believe this stems from having antiquated systems and structures that are siloed. Different divisions within a bank often don't communicate automatically with one another, requiring manual interventions and workarounds to achieve this. As the major banks have worked to try to address their tech debt, these mounting costs have eaten into their profitability, as highlighted in Figure 7.

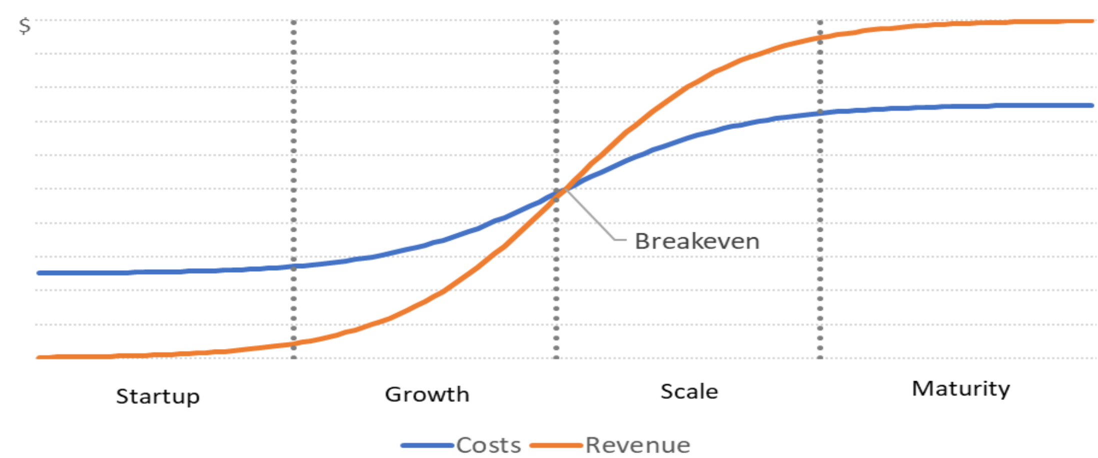
Figure 7: Costs to income ratios for major Australian Banks

Source: APRA; June 2021.

Contrast the above with the typical leverage of a technology company. These companies are often criticised by old fashioned investors "because they make no money" early on in their start up and growth phases. Figure 8 which charts revenue and cost S-curves* highlights this point.

***S curve:** Known as a sigmoid function, an S curve is a mathematical function. S curves are often used in innovation to explain the often slow, early beginnings as a business model or technology is developed. As a steepening inflection point is reached, progress and adoption accelerate as the business model attains scale, and ultimately maturity.

Figure 8: S curves – revenue, cost, and profitability across the lifecycle of a company



Source: Antares Equities; September 2021.

What is often missed, is that the two curves (revenue and cost) are symbiotic. When cost is deployed, a tech company generally has instant feedback through the revenue line. Hence the revenue curve follows the cost curve. A tick up in revenue means the cost is well-spent and the return on that investment is clear. If the costs are not well spent, the company may iterate its solution and redirect investment until a point where return on investment is demonstrated. In such an instance, a company remains loss making through its start-up and growth phase until such point it reaches breakeven.

Given technology companies are often pioneering new markets or disrupting old ones, the imperative is to get to scale. Technology platforms lend themselves to monopoly - think Google, Microsoft, Facebook etc. The names themselves are by-words for the services they offer because they often grow to become the dominant or only provider of those services in their markets.

Historically these technology companies have been more focused on sectors such as social media, marketplaces, and enterprise solutions. This is changing. Afterpay is a Fintech and its success has shown that the banks are vulnerable to technologically driven challengers.

The Afterpay opportunity – customers and merchants

Afterpay in numbers:

The company is only **6** years old

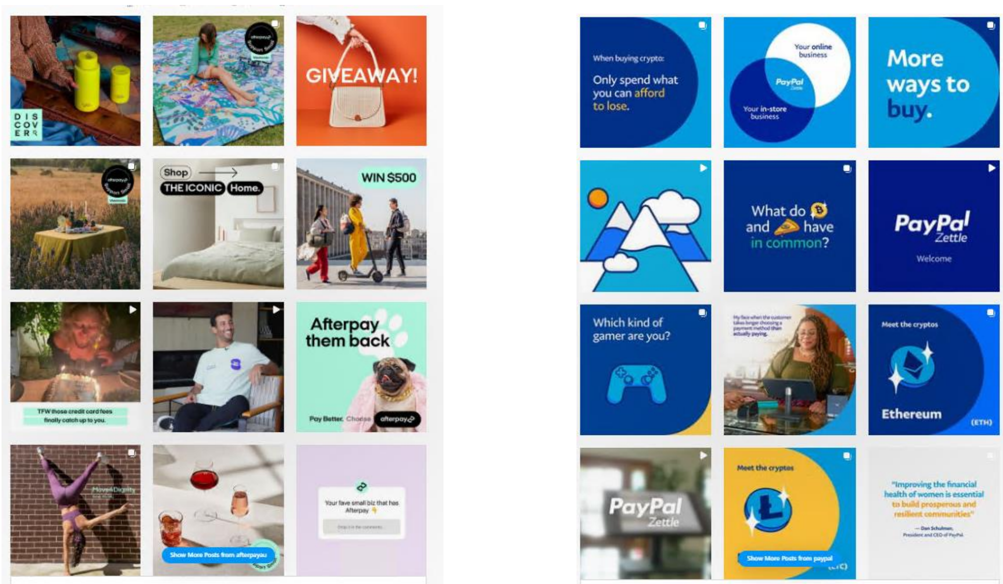
It has **3.6 million** customers

They are, on average **35** years old

In other words, they are the next generation of consumers, house buyers and consumers of financial products, but they have very limited relationships with Australia's banks.

In Australia, not only does Afterpay have 3.6m customers, on the other side of the Afterpay model are over 50,000 merchants. Most of these merchants are SMEs that are happy to pay an average of 4.0% of the value of a transaction to Afterpay for the referrals Afterpay provides. It's not about the cost. It's about the facilitation and the revenue the merchant receives. While it is cheaper to use an EFTPOS terminal supplied by a major bank, those terminals merely enable a transaction without providing additional revenue benefits to the merchant. The same can be said for several of Afterpay's competitors who provide buy-now-pay-later services but offer very little else to the merchant by way of leads. A comparison between Afterpay and competitor Paypal's Instagram pages illustrates the fact that Afterpay is focussed on delivering leads to sellers, while Paypal appears more focused on Paypal.

Figure 9: Instagram page highlights the benefit Afterpay brings to merchants
Afterpay (left) vs Paypal (right)



Source: Afterpay & Paypal Instagram pages; September 2021

Inserting Square into the mix with Afterpay accelerates the disruption

When you insert Square's Seller business into this mix, it can be argued that the relationship between Australia's four major banks and their SME customers comes under significant threat. Square can leverage the pre-existing Afterpay relationship and provide that merchant with a superior, fully integrated point-of-sale system with an ecosystem of useful products that aid their efficiency and access to capital. These same merchants are already using Afterpay and hence are focused on the facilitation of more transactions, rather than cost saving to drive their business. They are businesses looking to grow.

On the other side of the equation is the tie up between the 3.6m Australian Afterpay consumers and Square's Cash App if it is launched here. Afterpay has been piloting a similar product already in Australia with Westpac, branded Afterpay Money. Given Afterpay owns the relationship with the consumer, not Westpac, it is Westpac that is paying Afterpay for the access to the customer. This is not to criticise Westpac – we believe they are simply making a rational decision - if you can't beat them, join them. The bank would no doubt be aware that while JP Morgan took thirty years and five major acquisitions to build a 60m strong account holder base, it has taken Square's Cash App just seven years of organic growth to achieve the same.

Therefore, our thesis is that the speed at which Square + Afterpay can disrupt traditional banking services on both the merchant and consumer side is accelerated by combining Square's Seller and Cash App businesses with Afterpay and growing the businesses together.

So the questions we pose are: Should a portfolio have some of its financials exposure in the nimble and growing fintech sector? And how much exposure to Australia's aging banking structure is optimal?

Won't the banks fight back?

We observe that they already are, some by partnering with Afterpay competitors or copying Afterpay's products. The case study below suggests why they may not be as successful as some may think.

The Innovation Stack: Square has already seen Amazon off

Square (SQ) is one of the few companies in the world who have been able to successfully defend against Amazon. Amazon copied their product with a functionally better card reading device (it didn't move around when plugged into the mobile headphone jack like Square's did) and lower merchant fees (1.95% vs 2.75%), but after a year or so pulled out of the market and gave their customers SQ devices. Surprisingly, when Amazon entered the market the SQ board decided to do nothing in response, after considering a variety of ways to defend. This suggests there are difficulties for any competitor, no matter how cashed-up, in trying to copy the Square model.

Jim McKelvey (co-founder of Square) reflects on the difficulties of replication in his book, "The Innovation Stack", 2020, Portfolio, New York. The basic premise is:

- True innovation is about solving a problem that is new and novel (in Square's original case providing SMEs with a card processing system when Visa and Mastercard had refused);
- This requires new and novel solutions.
- When you solve that solution, two new problems invariably pop up. As you solve those two problems, more problems pop up and so on.
- As you go about solving these problems, because they are interconnected and related, it forms an "innovation stack" which becomes a competitive advantage.
- When others (such as Amazon) come in and try to copy the solution – they tend to only copy one or two elements of the stack;
- Mathematically, their chances of copying an innovation stack are very low, particularly where there are multiple layers of the stack.

We have seen this innovation stack play out with Afterpay – there are many copies, but few have been able to replicate its success because, in our view, they lack the same nuanced interconnected web of innovation.

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