



Capital  
Markets

October 15, 2020

## Square, Inc.

### Building a Platform for Financial Services

**Our view:** We believe SQ could be further along in building a platform for financial services than investors realize, which suggests a larger L-T monetization opportunity than originally expected. Raising estimates and increasing target price to \$240 (was \$200).

#### Key points:

**A Platform for Financial Services.** We think the evolution of SQ's ecosystems is further along the path of creating a Platform for Financial Services than investors realize, which satisfies our 4-Pillars of Banking (deposits, spending/disbursement, lending, services/investing). As a result, the monetization opportunity, especially for Cash App, is higher than previously expected, thus we are forecasting Cash App to generate FY22e revs, ex-bitcoin of ~\$3.2B, growing ~75% on a CAGR from '19-'22e, representing ~55% of net revenues, up from ~27% in FY19.

**As a quasi-deposit gatherer, Cash App has significant monetization opportunity.** We think Cash App's evolution highlights its journey from products that pass through funds (P2P), to products that enable the trapping of funds (spending, direct deposit & investing). In Q2/20, stored customer funds ("deposits") in Cash App increased to \$1.7B, up +250% y/y, which are increasingly being monetized by Cash Card (attached rates ~23% in Q2/20 vs. ~21% in Q4/19; we forecast ~33% in Q4/22e). We estimate Cash App gross profit dollars will grow ~4x that of Seller (~79% vs. ~18%, based on a '19-'22e CAGR), resulting in a positive mix shift that should drive long-term value.

**Seller ecosystem could be enhanced by launching a bank.** On Seller, we see an ecosystem that is designed & built to drive GPV, with a cohesive product portfolio which historically has generated net revenue retention rates north of 100%. We believe the next iteration will be to leverage its new ILC, Square Financial Services, which SQ is preparing to launch in FY21, to both enhance its lending capabilities, as well as carve out more commercial depository opportunities. We forecast the seller ecosystem will generate ~\$2.6B in net revenues (revenues less transaction costs), growing ~18% on a CAGR from '19-'22e and representing ~45% of net revenues.

**Increasing estimates, target price and reiterating Outperform.** After taking a deeper looking into SQ's two ecosystems separately, we are increasing our estimates across the board. Specifically, for FY22e, which represents our largest increase, we are taking adj. net revenues up ~27% (9% above consensus), adj. EBITDA up ~13% (~15% above consensus), and adj. EPS up ~10% (18% above consensus). Correspondingly, we are increasing our target price to \$240 from \$200, or 21x our FY22e EV/adj. net revenue, which is in line with similar software/payment focused peers.

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**Sector: Payments, Processors & IT Services**

### Outperform

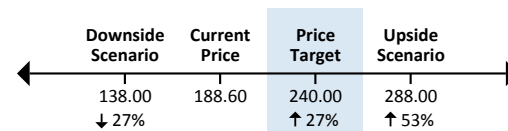
NYSE: SQ; USD 188.60

**Price Target USD 240.00 ↑ 200.00**

#### WHAT'S INSIDE

<input type="checkbox"/> Rating/Risk Change	<input checked="" type="checkbox"/> Price Target Change
<input type="checkbox"/> In-Depth Report	<input checked="" type="checkbox"/> Est. Change
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#### Scenario Analysis\*



\*Implied Total Returns

#### Key Statistics

Shares O/S (MM):	500.0	Market Cap (MM):	94,300
Dividend:	0.00	Yield:	0.0%
		Avg. Daily Volume:	10,351,600

Shares out and Enterprise Value assume a fully-diluted share count.

#### RBC Estimates

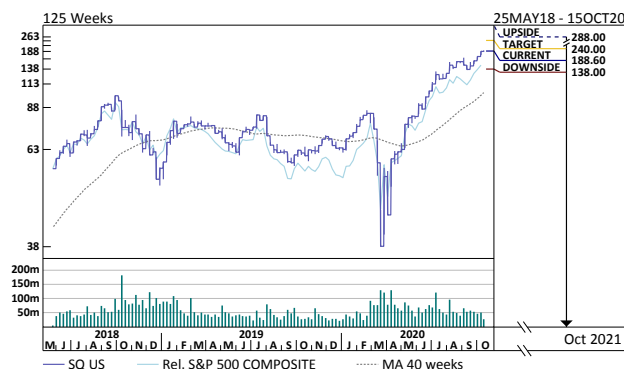
FY Dec	2019A	2020E	2021E	2022E
<b>Revenue</b>	2,128.8	2,983.9	4,158.6	5,612.0
Prev.	2,274.7	2,909.1	3,638.5	4,434.6
<b>EBITDA, Adj</b>	428.0	325.5	767.5	1,262.1
Prev.	416.9	331.6	756.8	1,112.1
<b>EPS, Adj Diluted</b>	0.83	0.51	1.24	2.14
Prev.	0.80	0.53	1.25	1.95
<b>P/AEPS</b>	NM	NM	NM	NM
<b>Revenue</b>	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>
2019	442.5A	519.4A	561.3A	605.6A
Prev.	489.1A	562.8A	602.2A	620.7A
2020	615.9A	677.5A	811.6E	878.8E
Prev.			789.5E	826.2E
2021	909.9E	1,013.4E	1,079.9E	1,155.5E
Prev.	812.9E	891.1E	942.7E	991.9E
<b>EBITDA, Adj</b>				
2019	65.0A	107.5A	134.8A	120.6A
Prev.	61.7A	105.3A	131.3A	118.5A
2020	9.3A	97.9A	100.2E	118.0E
Prev.			107.3E	117.0E
2021	177.9E	194.9E	179.3E	215.4E
Prev.	170.8E	182.0E	187.3E	216.6E

Revenue: shown on a net adjusted basis, ex-Caviar, and excludes transaction and bitcoin costs.  
EBITDA, Adj: shown ex-Caviar  
All values in USD unless otherwise noted.



## Target/Upside/Downside Scenarios

Exhibit 1: Square, Inc.



Source: Bloomberg and RBC Capital Markets estimates for Upside/Downside/Target

### Price target/base case

Our price target is \$240 or 21x CY22E EV/ adjusted revenue, which is in-line with software/payment peers that generate similar revenue growth but slightly higher than historical averages, given our believe that SQ will emerge as a structural winner post the currently challenged macro environment. This target supports our Outperform rating.

### Upside scenario

Our upside scenario is \$288, or EV/adjusted revenue of 23x our upside CY22 revenue estimate of \$6.17B (10% premium to our base case estimate), which we believe is appropriate if the company can accelerate revenue growth post its recent round of incremental investments, which are designed to expand the TAM and reinvigorate its core seller growth.

### Downside scenario

Our downside scenario is \$138, or EV/adjusted revenue of 14x our downside CY22 revenue estimate of \$4.77B (15% discount to our base case estimate), which we believe is appropriate if the revenue growth disappoints despite the incremental investments.

## Investment summary

Our positive thesis on Square is based on:

- The significant monetization opportunity for Cash App, as Cash Card usage and attach rate both increase;
- The company's Seller solutions set creating a cohesive roadmap to additional wallet share in the micro & SMB market;
- The large long-term market opportunity in micro and SMB commerce & technology;
- The company's technology allows it to grow the core payments business more quickly than the market;
- As its Seller clients take on more of the solution set, revenues pool, retention rises, and the take-rate remains relatively stable;
- International expansion over the longer term.

## Potential catalysts

These factors should support the company growing revenues at +35% CAGR over the near term (next three years) and allow it to achieve continued EBITDA margin leverage. In our opinion, continued adoption of Square's consumer products, as well as Square's integrated hardware, software and services solutions that position the company to benefit from ongoing card acceptance penetration at smaller merchants, enable share gains against existing solutions that lag from a technological or efficiency-basis. Non-payment specific solutions, furthermore, help to lock in clients, broaden the revenue stream, and ultimately tie back to payments.

## Risks

We believe there are three broad risk categories: 1) macroeconomic concerns, especially given the current pandemic; 2) execution risks; and 3) competition. Since Square's business model is intimately tied to micro and small businesses, a slowdown in consumer retail sales, or a decision by individuals to shift away from Cash App, could impede the achievement of our price target. Additionally, we note that: (a) payments is a very competitive landscape; (b) payments is also highly regulated; and (c) Square is dependent on services from the networks and merchant acquirers that may become competitors. Finally, we note execution risk associated with: (a) the CEO's dual leadership roles; (b) history of losses; and (c) the positive effects of software & data products revenue included in our model.



## Analyst's View

Although Square has been building out components of financial services for several years, when viewed from a portfolio context, we believe the company could be further along than investors realize. From our perspective, it looks very much like a Platform for Financial Services, as SQ's product catalog now satisfies our 4-Pillars of Banking: 1) deposit gathering & savings, 2) spending/disbursement of funds, 3) lending (commercially and for consumers), and 4) additional services (investing of stocks/ETFs, bitcoin). It's our view that the L-T monetization opportunity derived from this platform could be meaningfully higher than we originally estimated. As a result, we are increasing our adj. net revenue and adj. EBITDA estimates for FY21 & FY22 by 14%/27% and 1%/13%, respectively. Given our higher FY22 revenue estimate, we are increasing our target price to \$240 from \$200.

### Exhibit 2: Square's ecosystems satisfy our 4-Pillars of Banking

	<b>Storage of Funds</b> <i>( deposit gathering / savings )</i>	<b>Transactions &amp; Payments</b> <i>( processing / spending / disbursements )</i>	<b>Lending of Funds</b> <i>( personal loans / growth capital )</i>	<b>Additional Services</b> <i>( utility functions / advisory )</i>
<b>Cash App</b>	Cash App Balance = storage of customer funds	P2P payments, Cash Card, Instant Deposit, Direct Deposit, Cash for Business	Cash App pilot of small value, short-term loans	Investing
<b>Seller</b>	Square Balance = daily Seller transactions	Point-of-Sale (POS) / card acceptance, Invoices, Payroll, Instant Transfer, Square Card	Square Capital = Core Flex Loans	<i>Could the ILC help to fill this gap?</i>

Source: Company data, RBC Capital Markets estimates

## Quietly assembling a Platform for Financial Services

The evolution of products & features for both Square's Cash App and Seller ecosystems has moved the company closer, in our opinion, to many of the roles fulfilled by a traditional Financial Institution. As the company continues to innovate and drive additional engagement, we believe the monetization opportunity, especially for Cash App, could prove to be significant. We estimate that Cash App revenue (ex-bitcoin) in FY22 will be ~\$3.2B and ~37% share of total revenue (vs. ~15% in FY19) growing at a 3yr CAGR of ~75%, while Cash App gross profit (also ex-bitcoin) will be \$2.6B and ~53% of total gross profit (vs. ~25% FY19) growing at a 3yr CAGR of 79%. We estimate that Seller total revenue in FY22 will be \$5.4B with a 3yr (2019-2022) CAGR of ~16%, while Seller gross profit will be \$2.3B (~47% share) and grow at a 3yr CAGR of 18%.

The overall strategy of these ecosystems has enabled Square, in our opinion, to create a comprehensive product set for customers (both consumers & sellers) that not only provides critical bank-like functions, but also puts the company ahead of competitors and creates risk for traditional FIs. Taking a step further, we would argue that Square is well on its way to creating a closed-loop type system, whereby the company is able to effectively "trap" funds within its ecosystem (in a 'Cash App Balance' or 'Square Balance'), monetizing the use of products/features inside the system as well as the transfer of funds in/out.

For example, with Cash App, at the end of Q2/20, Square held \$1.7B of 'stored' customer funds on its balance sheet (up ~156% vs. Q4/19 & up 257% y/y); also in Q2/20, the attach rate of Cash Card was over 23%, up from ~21% in Q4/19 and ~16% in Q4/18. We estimate that Cash Card is now larger than Instant Deposit, which we think illustrates how Square has shifted customers' behavior to retain funds within the ecosystem, while also creating ways to monetize the velocity of money as it leaves (i.e., spending via Cash Card).

For Seller, we would highlight paid versions of its vertical-specific POS software (Retail, Restaurants, etc.), paid add-ons like Marketing & Loyalty, and the recent launch of two new



features for Square Payroll: On-Demand Pay (for employees) and Instant Payments (for employers) that leverage the Seller and Cash App ecosystems, thereby providing incremental benefit to customers that use both. With On Demand Pay, employees of a business that uses Square Payroll can transfer up to \$200, or 50%, of earned wages between pay periods to Cash App for free, or to a linked debit card for a fee (1% per transfer). With Instant Payments, Sellers that utilize Square Payroll can fund their payroll using the money in their Square Balance, which we see as increasing the functionality of this pool of funds (payment source) and nullifying potential reason why Sellers might look to transfer funds out (to make payroll).

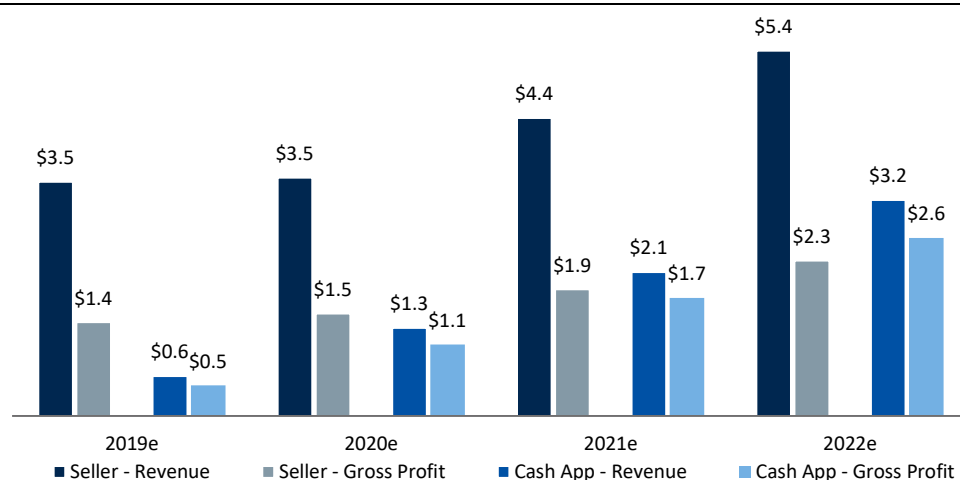
Finally, we believe Square's launch of its bank in 2021, Square Financial Services, will provide additional flexibility and increase efficiencies for Square Capital. Although we believe it will be focused on Square Capital and its Seller ecosystem to start, we would expect that over time, the company could explore features for Cash App as well (potentially including FDIC insurance for Cash App Balances, a savings account, or even an installment/BNPL type product).

### Financial implications for the model = numbers move higher

With its Q2/20 10-Q filing, Square broke out revenue for its Seller and Cash App as separate segments. We used this additional detail to analyze each ecosystem separately, allocate products/features to individual revenue type (transaction vs. subscription, etc.), and forecasted revenue out to FY22. Based on our analysis, we are increasing our adj. net revenue estimates by ~3% in FY20, ~14% in FY21, and by ~27% in FY22. Relative to our prior estimates, a majority of the increase comes from higher estimates for Subscription and Services-based revenue, driven by Cash App (Cash Card & Instant Deposit). Flowing through our updated estimates into our model, we tweak our FY20 adj. EBITDA estimate 2% lower but increase our FY21 & FY22 adj. EBITDA estimates by 1% & 13%, respectively.

Our estimates are rooted in a granular approach to each ecosystem's revenue build, which we think is more closely aligned to the revenue generation ability of SQ's individual products/features. As we worked through our analysis, three things stood: 1) Cash Card can drive meaningful Subscription and Services-based revenue over time, as usage & attach rates move up (currently ~20x per month & ~23%, respectively); 2) we estimate that Cash App's gross profit dollars will grow ~4x faster than Seller's, on a CAGR basis (from 2019-2022); and 3) we believe Cash App imbeds a modest GPV driver (via Cash for Business) that is currently under appreciated by investors. Our forecasts for total Seller & Cash App (ex-bitcoin) revenue and gross profit are shown in Exhibit 3.

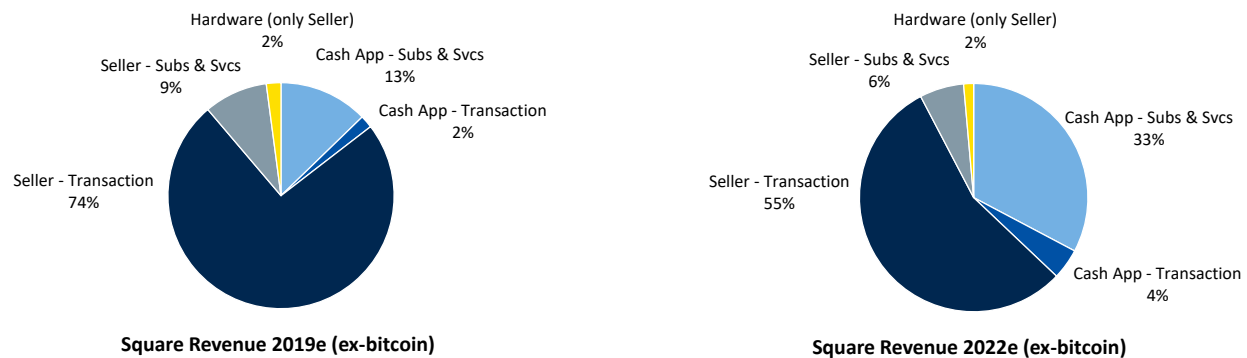
Exhibit 3: SQ's Total revenue (ex-bitcoin) & gross profit, split by ecosystem



Source: Company data, RBC Capital Markets estimates

**Share of total revenue by ecosystem & type.** Looking ahead to 2022, we estimate that Cash App revenue (ex-bitcoin) will see a meaningful increase in relative share, moving to ~37% (from ~15% in 2019e), as shown in Exhibit 4. That year (2022), we forecast share of total revenue (ex-bitcoin) will be composed of Seller Transaction-based at ~55% (down from 74% in 2019), Cash App Subscription and Services-based at 33% (up from 13%), Seller Subscription and Services-based at 6% (vs. 9%), Cash App Transaction-based at 4% (vs. 2%), and Hardware (Seller) at ~2% (vs. 2%), also in Exhibit 4.

Exhibit 4: Square Total Revenue share (ex-bitcoin), 2019e (left) vs. 2022e (right)



Source: Company data, RBC Capital Markets estimates

Although each ecosystem has three revenue categories across various products, shown in Exhibits 5 & 6, the company's two most important revenue categories are Transaction-based revenue, and Subscription and Services-based revenue; when combined, we estimate these categories will drive ~98% of total (ex-bitcoin) revenue in 2020, 2021 & 2022.

Exhibit 5: Cash App ecosystem product monetization & revenue categories

	Engagement Drivers	Revenue Stream	Transaction-based	Subscription and services	Bitcoin
<b>SENDING MONEY</b>	Peer-to-Peer	Instant Deposit Cash for Business Credit Card funding	●	●	
<b>SPENDING MONEY</b>	Boost (rewards) Stored balance Direct Deposit	Cash Card interchange ATM withdrawals Interest Income		●	
<b>INVESTING MONEY</b>	Bitcoin Equity Investing	Bitcoin			●

Source: Company reports



Exhibit 6: Seller ecosystem product monetization & revenue categories

		Transaction-based	Subscription and services	Hardware
SIDECAR PAYMENTS	POS App with payments usage only	●		
	Invoices, Virtual Terminal, Developer, APIs/SDKs, Third Party Apps	●		
SOFTWARE AND INTEGRATED PAYMENTS	Square for Retail, Restaurants, Appointments, Square Online Store	●	●	
	Team Management, Marketing, Loyalty		●	
FINANCIAL SERVICES	Square Card, Instant Transfer		●	
CAPITAL	Core Flex Loans, Installments		●	
HARDWARE	Square Register, Terminal, Stand, and Contactless and Chip Reader, Third Party Peripherals			●

Source: Company reports

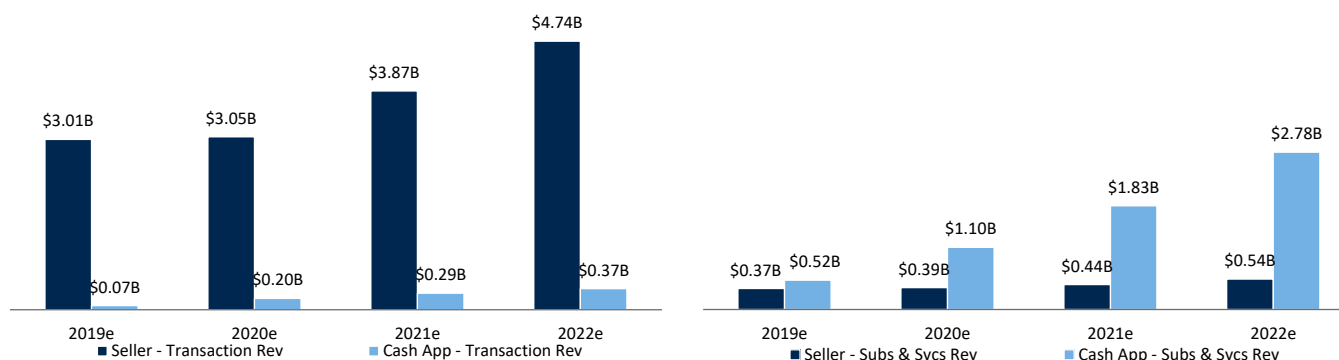
**Transaction-based revenue.** Although we expect nearly all of total transaction-based revenue (shown on the left side in Exhibit 7) to be driven by Seller GPV, we'd call out that Cash App contributed a not-insignificant amount of GPV in H1/20 as well (its share of total GPV was ~4% in Q1/20 & ~8.5% in Q2/20). We believe Cash App GPV was driven by credit card processing via "Cash for Business" (a business account option *within Cash App* that provides basic card processing/acceptance) that stemmed from shifting behavior due to the COVID-19 pandemic (aversion to cash); moving forward, we expect this behavior to remain. By Q4/20, we estimate that Cash App could generate ~\$240M in transaction-based revenue at an annual run-rate, and by FY22 could be ~\$370M or 7% of total transaction-based revenue (or ~\$140M, ex-transaction costs, also ~7% of net transaction-based revenue).

**Subscription and services-based revenue.** We think Cash App is the largest growth driver for this revenue category (shown on the right side in Exhibit 7), due to: 1) **Cash App's Cash Card** (a free debit card) and 2) **Cash App's Instant Deposit** (a service for faster access to funds). In H1/20, Cash App's Subscription and Services-based revenue was 72% of total Subscription and Services-based revenue (vs. 57% in H1/19), up 116% y/y; by FY22, our forecasts imply that share will move up to ~84%. On the Seller side, we expect revenue will grow at a rate that is more closely aligned with Seller Transaction-based revenue & Seller GPV, albeit with a somewhat slower start as Sellers continue to recover from the pandemic. For H1/20, Seller Subscription and Services-based revenue increased ~7.5% y/y.

Digging into those two Cash App components helps to better frame the revenue drivers here, in our opinion: With (1) **Cash Card** (a Visa debit card that can be used wherever Visa is accepted), Square generates interchange revenue when customers use their card to complete a purchase. Because of the transactional nature of this revenue, as customers increase their frequency of use in making a purchase (and/or with higher attach rates to Cash App, currently ~23%), the company can generate higher revenue. Interchange fees (which are set by the networks, in this case Visa) for this product/card are 1.15% + \$0.15 per swipe; on an average ticket of \$20, we estimate SQ's gross fee is ~190bps, or ~\$0.38 per swipe. We'd note that this debit card is an exempt (non-regulated) prepaid debit card that carries higher fees vs. a regulated prepaid debit card at (0.05% + \$0.21). As a result of its exempt status, Square is able to generate higher revenue because the card is issued by a bank partner with less than \$10B in assets. With (2) **Instant Deposit**, customers are charged 1.5% for instant transfer of funds to a linked debit card (standard deposits arrive in 1-3 days and are free); we would expect that as the Cash Card attach rate increases & more customers use Cash Card to spend their Cash App Balance, growth of this product will slow over time.



Exhibit 7: Square Seller vs. Cash App revenue, Transaction-based (left) & Subscription and Services-based (right)



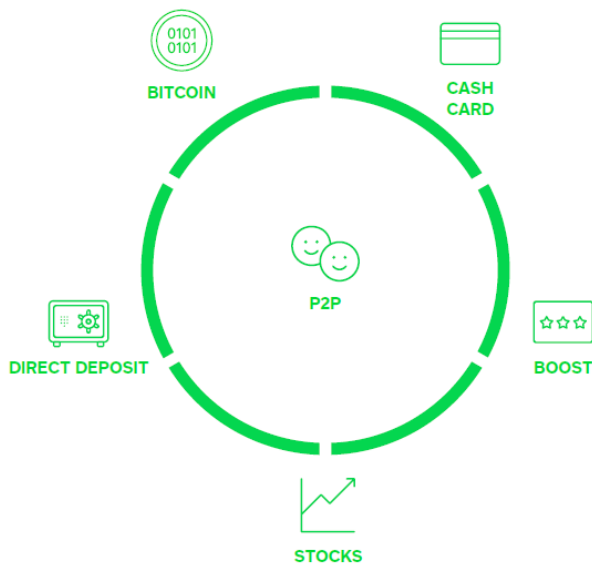
Source: Company data, RBC Capital Markets estimates

### Evolution of the Cash App ecosystem

Cash App launched in 2013 as a peer-to-peer (P2P) payment service, designed to compete with existing players. Four years later, in mid-2017, the company launched Cash Card, a Visa-branded debit card that enabled users to spend their Cash App balance at a point-of-sale. In early 2018, Square launched support for buying/selling bitcoin and separately launched support for direct deposit of paychecks into Cash App. In late 2019, Square launched free stock trading via the app. In addition to demonstrating an expanded product offering, **we think this evolution highlights the ecosystem's journey from products that pass through funds (P2P), to products that enable the trapping of funds (direct deposit, spending & investing).** Collectively, we think these products provide meaningful value to customers, as demonstrated by the mobile app's consistent ranking as a top free app in both the Google Play store & Apple's App Store.

**Level setting the ecosystem.** Square's Cash App ecosystem is composed of the following products (Exhibit 8), that we think are designed to help individuals manage their money & encourage active engagement with the ecosystem: P2P payments, Cash Card (a debit card for spending & ATM access), Direct Deposit, Cash Boost (instant merchant discounts for Cash Card), Bitcoin investing, and Stock/ETF investing. Although each product provides a unique solution & value proposition, when taken collectively we see these products fulfilling many, if not all, of the basic banking functions a customer might require: storage & receipt of funds, access to spend the funds, and investment of funds. Additionally, the company recently piloted a feature for short-term loans to a small number of users, which would satisfy the lending function as well. When viewed from a portfolio context, we think Square's Cash App ecosystem looks very much like a Platform for Financial Services and satisfies our 4-Pillars of Banking: 1) deposit gathering & savings, 2) spending / disbursement of funds, 3) lending of funds, and 4) investing (additional services).

Exhibit 8: Square's Cash App ecosystem



Source: Company reports

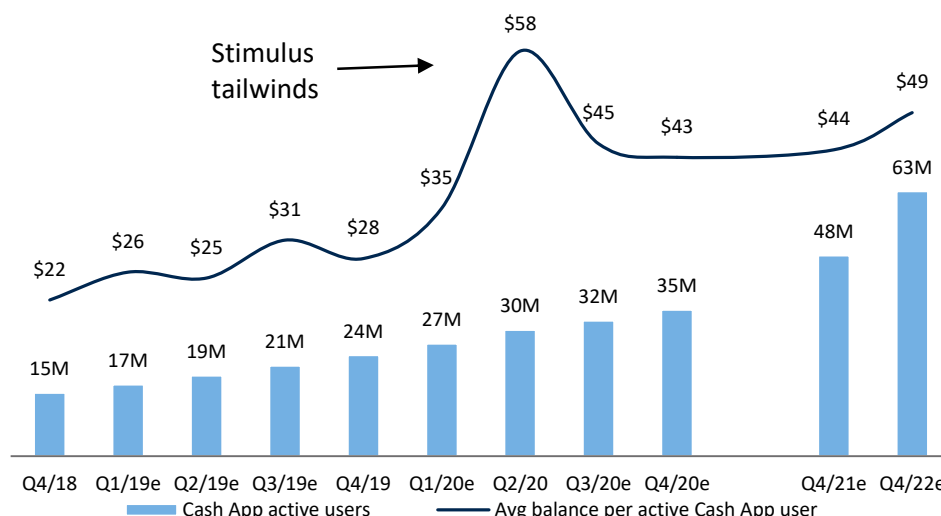
**The flywheel effect.** We think this ecosystem revolves around a “Cash App Balance” that users engage with throughout their day-to-day for various transactions (not dissimilar to a checking account at a traditional bank), and Square has products/features in place to monetize these stored funds. Per the Cash App Terms of Service, a user’s Cash App account balance can be funded in a number of different ways: 1) adding funds from a linked bank account, 2) via direct deposit from an employer, 3) adding funds from a linked debit card, and/or 4) receiving a P2P payment via Cash App.

According to the company, the more products that a user engages with, the higher the lifetime value of that customer. For example, during its Q2/20 earnings conference call, management said that customers who use two or more products generated 2x to 3x more revenue, vs. customers who only use P2P payments. Intuitively, we think this makes sense, as use of additional products = higher engagement and greater likelihood that a user would use a monetized feature of this ecosystem. Despite the somewhat transactional nature of this ecosystem, we would also note that Cash App users have increasingly chosen to store funds in their Cash App Balance, evidenced by the increase of ‘Customer funds’ held on SQ’s Balance Sheet. At the end of 2019, customers had stored balances of \$676M (up 102% y/y), at the end of Q1/20, stored balances were \$945M (up 112% y/y), and at the end of Q2/20, stored balances were over \$1.7B (up 257% y/y). Given the economic backdrop during H1/20, we believe some but not all of the growth in Q2/20 benefited from stimulus payments in the US, which we expect to normalize in H2/20 and FY21.

Another piece to this ecosystem’s story is the avg. balance per active Cash App user, which has also increased over time, as shown in Exhibit 9. We believe a higher balance per active Cash App user is a positive indication that customers continue to leverage and trust this ecosystem, not only with money they are transacting but also with money they are storing. We also think it supports a view that once funds have been moved inside the ecosystem, there’s a level of stickiness to those balances & a desire to interact with those funds from within the ecosystem (storing / spending / investing, etc.).



Exhibit 9: Cash App active users & avg. balance per active user



Source: Company reports, RBC Capital Markets estimates

As Square now has the regulatory approval to launch an ILC, or industrial bank, we think a natural step for the company would be to explore FDIC insurance on balances, or potentially a savings account as part this ecosystem. In our opinion, these would provide even greater incentive to store funds in a Cash App Balance, increasing overall engagement, and solidifying Square's role as a trusted Financial Institution for those customers leveraging its ecosystem.

### Evolution of the Seller ecosystem

We observed a similar evolution with its Seller ecosystem that began with the company's original magstripe reader (~2010) for card payment acceptance and processing, to its now comprehensive hardware devices & vertically specialized point-of-sale software (Retail, Restaurants, Appointments). In 2014, the company launched Square Capital, a lending and growth capital program for its Sellers with payback tied to their Square transactions. In early-2019, the company launched the Square Card, a MasterCard business debit card that provides sellers with real-time access to their funds (as soon as they have made a sale). Along the way, Square added additional products and features to make its ecosystem more robust for Sellers, including Square Payroll (2015) and Team Management (2019). At YE19, the company had over 30 distinct products in this ecosystem.

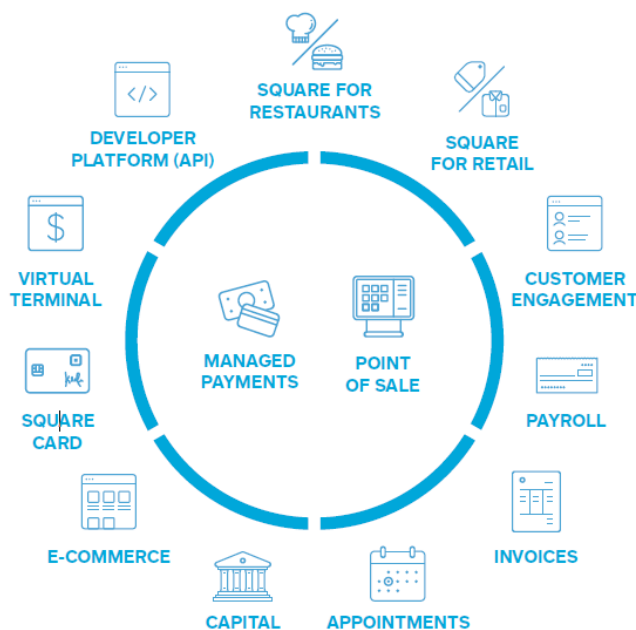
**Designed & built to drive GPV.** Although this ecosystem may have more products, we think it's a more straightforward story: the company facilitates and simplifies the acceptance of card-based payments and has launched complimentary products/features to help Sellers drive growth and run their businesses. As the ecosystem has expanded in scope and products, we believe Sellers have had fewer reasons to look elsewhere for functionality (i.e., no need to use a separate product for inventory/payroll), which creates a deeper relationship, in our opinion. Thus, as Sellers increase in number and/or size, Square is able to process a larger amount of GPV, which ultimately drives higher revenue. Along the way, the company has also driven better unit economics: from 2015 - 2019, the number of active Sellers was up 1.7x, while gross profit per Seller increased 2.3x.

**Level setting the ecosystem.** Square's Seller ecosystem (Exhibit 10) is a collection of products and features (across software, hardware, & financial services) that help sellers start, run and grow their business. On the software side, and core to the ecosystem is Square's Point-of-Sale (POS) software products, which range from a general purpose version, to a number of

vertically specialized versions (Square for Restaurants/Retail, Appointments), to a web-based version (Virtual Terminal), to a digital invoicing solution (Invoices). The company has also built software that helps sellers launch & run an online store, as well as engage with their customers via loyalty & marketing campaigns. In addition, Square provides a developer platform that enables payments and commerce integrations. On the hardware side, the company offers custom designed devices that can process all major card payment forms as well as run its POS software. Under the financial services umbrella is Managed Payments (effectively card payment acceptance; also core to this ecosystem), Instant Transfer, Square Card, Square Capital and Payroll. Although Square stopped offering its Square Installments solution in March, we would expect the company to eventually explore a product with similar functionality because of the growth and LT opportunity that the BNPL market represents.

We see SQ's ability to provide Sellers a set of tools to not only accept card payments, but also access growth capital and spend earnings from within the ecosystem, as a comprehensive set of products & features that provides businesses a set of bank-like functions (similar to Cash App for an individual). When viewed as a portfolio, we think the company's Seller product catalog begins to look very much like a Platform for Financial Services.

Exhibit 10: Square's Seller ecosystem



Source: Company reports

**Moving deeper into Financial Services, in support of its Sellers.** This past March, Square announced that it received conditional FDIC approval for deposit insurance related to its Industrial Loan Company (ILC) bank charter; the company also said that it received charter approval from the Utah Department of Financial Institutions. With the approvals, Square expects to launch its bank, Square Financial Services, in 2021, which will operate independently, but as a direct subsidiary of Square, Inc. According to the FDIC, one of the conditions would require the proposed bank to maintain levels of capital that are significantly higher than typical FDIC-insured banks ([link](#)); it also wrote that it has been more than a decade since it approved deposit insurance for an ILC.

According to Square, the primary purpose of the bank will be to offer small-business loans for Square Capital's commercial lending business, as well as to offer deposit products. Following



the launch, we believe a top priority will be to transition Square Capital loans from its current industrial bank partner, to Square Financial Services. Following that transition, we think a solution to provide FDIC insurance for Sellers' Square Balance seems like a logical next step. We believe that FDIC insurance is a tangible benefit to Sellers that could lead to a higher level of trust with Square, potentially removing a reason to transfer funds out (to an FDIC insured account), thereby providing Square with another opportunity to retain funds within this ecosystem. For Square itself, we think owning an ILC could create additional efficiencies from direct access to services from the Federal Reserve System, including electronic funds movements and ACH payments that may further support margins as the company continues to scale.

### Conclusion

Based on our work, we believe Square has built a monetization machine around its financial services platform that spans both its Cash App and Seller ecosystems. Based on the current mix of Cash App, we see 25%+ upside to the stock from here. Each side of this platform is ahead of the competition, in our opinion, and believe that the company should continue taking share from banks. We see significant monetization opportunities with Cash App, which could grow to represent 37% of total (ex-bitcoin) revenue, up from 15% in FY19; furthermore, we estimate Cash App's gross profit dollars will grow ~4x faster than Seller's on a CAGR basis, between 2019-2022. In addition, we expect that company's 2021 launch of its ILC bank will enable the company to imbed itself deeper in Financial Services, with a focus on its Seller ecosystem to start. As a result, we are increasing our adj. net revenue and adj. EBITDA estimates for FY21 & FY22 by 14%/27% and 1%/13%, respectively. Given our higher FY22 revenue estimate, we are also increasing our target price to \$240 from \$200 or 21x EV to CY22E adj. net revenue, in-line with a set of peers generating similar revenue growth.

**Valuation.** We base our 21x EV/adj. net revenue multiple on a set of software and payment peers, shown in Exhibit 11, that have similar revenue growth characteristics. Additionally, we selected this comp group because we think these peers also share common characteristics with Square, including a focus on and/or offerings for the SMB market, software that is SaaS based, and provide products in which to monetize payments.

Exhibit 11: SQ comp table of software and payment peers

Company	Symbol	Current price	Enterprise Value (\$B)	EV / Revenue			EV / EBITDA		
				CY20E	CY21E	CY22E	CY20E	CY21E	CY22E
BigCommerce	BIGC	\$106.0	\$7.2	50.4x	42.7x	35.1x	-	-	-
Bill.com	BILL	\$119.8	\$8.7	50.8x	40.9x	31.3x	-	-	-
Coupa Software	COUP	\$312.1	\$21.6	44.1x	34.9x	27.4x	316.2x	221.0x	139.5x
Intuit	INTU	\$345.3	\$86.7	10.9x	10.1x	9.1x	29.0x	26.2x	23.6x
Paycom Software	PAYC	\$372.9	\$21.0	25.4x	21.1x	17.3x	67.4x	54.0x	43.0x
Paylocity	PCTY	\$190.4	\$10.1	17.0x	14.4x	11.9x	64.8x	56.2x	41.5x
Shopify	SHOP	\$1,082.1	\$127.9	49.6x	37.6x	25.3x	484.7x	393.2x	241.3x
Wix.com	WIX	\$287.7	\$15.6	16.2x	12.8x	10.2x	157.0x	82.3x	60.9x
				<b>33.1x</b>	<b>26.8x</b>	<b>21.0x</b>	<b>186.5x</b>	<b>138.8x</b>	<b>91.6x</b>
<b>Square</b>	<b>SQ</b>	<b>\$187.5</b>	<b>\$91.1</b>	<b>30.5x</b>	<b>21.9x</b>	<b>16.2x</b>	<b>279.9x</b>	<b>118.7x</b>	<b>72.2x</b>

SQ = RBCe; remainder = FactSet

Source: FactSet, RBC Capital Markets estimates

## Valuation

Our price target is \$240 or 21x CY22E EV/ adjusted revenue, which is in-line with software/ payment peers that generate similar revenue growth but slightly higher than historical averages, given our believe that SQ will emerge as a structural winner post the currently challenged macro environment. This target supports our Outperform rating.

## Risks to rating and price target

We believe there are three broad risk categories: 1) macroeconomic concerns, especially given the current pandemic; 2) execution risks; and 3) competition. Since Square's business model is intimately tied to micro and small businesses, a slowdown in consumer retail sales, or a decision by individuals to shift away from Cash App, could impede the achievement of our price target. Additionally, we note that: (a) payments is a very competitive landscape; (b) payments is also highly regulated; and (c) Square is dependent on services from the networks and merchant acquirers that may become competitors. Finally, we note execution risk associated with: (a) the CEO's dual leadership roles; (b) history of losses; and (c) the positive effects of software & data products revenue included in our model.

## Company description

Founded in February 2009, Square is a leading provider of payment processing, point-of-sale (POS), financial, and marketing services for micro, small and mid-sized (SMB) merchants that work to democratize commerce by leveling the playing field for sellers of all sizes. The company also has financial services products to help individuals manage their money. The company currently generates a significant portion of its revenues from payments & POS services, in the US.

Square, Inc.  
Earnings Model  
(\$M except per share)

	FY 2018A	Mar-19 1Q19A	Jun-19 2Q19A	Sep-19 3Q19A	Dec-19 4Q19A	FY 2019A	Mar-20 1Q20A	Jun-20 2Q20A	Sep-20 3Q20E	Dec-20 4Q20E	FY 2020E	Mar-21 1Q21E	Jun-21 2Q21E	Sep-21 3Q21E	Dec-21 4Q21E	FY 2021E	Mar-22 1Q22E	Jun-22 2Q22E	Sep-22 3Q22E	Dec-22 4Q22E	FY 2022E
Revenues																					
Transaction revenue	2,471.5	656.8	775.5	816.6	832.2	3,081.1	758.1	682.6	880.5	931.3	3,252.5	926.5	1,039.7	1,082.9	1,104.8	4,154.0	1,114.3	1,284.5	1,341.9	1,369.4	5,110.0
y/y change	28.7%	25.6%	24.0%	24.6%	24.6%	24.7%	15.4%	(12.0%)	7.8%	11.9%	5.6%	22.2%	52.3%	23.0%	18.6%	27.7%	20.3%	23.5%	23.9%	23.9%	23.0%
Starbucks																					
y/y change																					
Subscription & services	443.4	172.3	208.0	238.9	266.4	885.5	296.2	346.3	396.3	447.3	1,486.1	482.2	541.7	592.2	656.4	2,272.5	711.5	798.9	861.3	947.8	3,319.5
y/y change	75.5%	147.6%	113.5%	88.6%	77.8%	99.7%	71.9%	66.5%	65.9%	67.9%	67.8%	62.8%	56.4%	49.4%	46.8%	52.9%	47.5%	47.5%	45.4%	44.4%	46.1%
Hardware	68.5	18.2	22.3	21.8	22.3	84.5	20.7	19.3	22.2	23.0	85.2	23.1	25.7	25.1	26.0	99.9	26.3	30.6	29.9	31.0	117.7
y/y change	65.4%	26.3%	21.2%	24.0%	22.6%	23.4%	13.5%	(30.0%)	2.0%	3.5%	0.9%	11.5%	33.0%	13.0%	13.0%	17.2%	14.0%	19.0%	19.0%	19.0%	17.8%
Bitcoin revenue	166.5	65.5	125.1	148.3	177.6	516.5	306.1	875.5	963.0	1,011.2	3,155.7	1,061.7	1,093.6	1,126.4	1,160.2	4,441.8	1,195.0	1,230.8	1,267.7	1,305.8	4,999.3
q/q change			90.9%	18.5%	19.7%	210.2%	72.4%	286.0%	10.0%	5.0%	511.0%	5.0%	3.0%	3.0%	3.0%	40.8%	3.0%	3.0%	3.0%	3.0%	12.6%
Total Revenue	3,149.9	912.8	1,130.8	1,225.5	1,298.4	4,567.6	1,381.1	1,923.6	2,262.0	2,412.8	7,979.5	2,493.5	2,700.7	2,826.6	2,947.4	10,968.2	3,047.0	3,344.8	3,500.8	3,653.9	13,546.5
y/y change	42.3%	42.4%	45.4%	45.5%	46.2%	45.0%	51.3%	70.1%	84.6%	85.8%	74.7%	80.5%	40.4%	25.0%	22.2%	37.5%	22.2%	23.8%	23.9%	24.0%	23.5%
Adjusted Revenue																					
Add: Deferred revenue adjustment	13	3.5	1.8	1.2	0.9	7.5															
Less: bitcoin costs	165	64.7	122.9	146.2	174.4	508.2	299.4	858.0	938.9	985.9	3,082.3	1,040.5	1,071.7	1,103.8	1,137.0	4,353.0	1,171.1	1,206.2	1,242.4	1,279.7	4,899.3
Less: Transaction Costs	1,559	409.1	490.3	519.3	519.2	1,938.0	465.8	388.1	511.5	548.1	1,913.4	543.2	615.6	642.9	654.9	2,456.7	661.9	762.8	797.0	813.4	3,035.2
Adjusted Net Revenue	1,439.4	442.5	519.4	561.3	605.6	2,128.8	615.9	677.5	811.6	878.8	2,983.9	909.9	1,013.4	1,079.9	1,155.5	4,158.6	1,214.0	1,375.7	1,461.4	1,560.8	5,612.0
y/y change	46.3%	58.4%	49.0%	43.3%	44.2%	47.9%	39.2%	30.4%	44.6%	45.1%	40.2%	47.7%	49.6%	33.0%	31.5%	39.4%	33.4%	35.8%	35.3%	35.1%	34.9%
Operating Expenses	50%																				
Product development	483.8	148.8	168.8	163.2	172.3	653.2	195.0	206.8	219.1	241.7	862.6	259.3	288.8	307.8	321.2	1,177.1	339.9	375.6	382.9	394.9	1,493.3
% of adjusted revenue	33.6%	33.6%	32.5%	29.1%	28.5%	30.7%	31.7%	30.5%	27.0%	27.5%	28.9%	28.5%	28.5%	28.5%	27.8%	28.3%	28.0%	27.3%	26.2%	25.3%	26.6%
Sales & marketing	395.1	128.5	150.8	143.3	183.3	605.9	194.5	238.1	331.1	334.0	1,097.7	273.0	324.3	361.8	369.8	1,328.8	333.9	399.0	431.1	441.7	1,605.6
% of adjusted revenue	27.5%	29.0%	29.0%	25.5%	30.3%	28.5%	31.6%	35.1%	40.8%	38.0%	36.8%	30.0%	32.0%	33.5%	32.0%	32.0%	27.5%	29.0%	29.5%	28.3%	28.6%
General & Administrative	312.4	93.5	91.6	107.0	114.2	406.3	129.5	136.4	150.2	167.0	583.0	182.0	194.6	205.2	219.6	801.3	233.1	258.6	268.9	287.2	1,047.8
% of adjusted revenue	21.7%	21.1%	17.6%	19.1%	18.9%	19.1%	21.0%	20.1%	18.5%	19.0%	19.5%	20.0%	19.2%	19.0%	19.0%	19.3%	19.2%	18.8%	18.4%	18.4%	18.7%
Transaction & advance losses	88.1	27.8	34.3	32.7	32.1	127.0	108.9	37.6	29.4	34.3	210.1	31.0	35.3	36.8	37.6	140.7	38.0	43.8	45.8	46.7	174.4
% of GPV	0.10%	0.12%	0.13%	0.12%	0.11%	0.12%	0.42%	0.16%	0.10%	0.11%	0.19%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%
Amortization of acq customer assets	4.4	2.1	1.3	1.0	0.9	5.3	0.9	0.9	0.9	0.9	3.6	0.9	0.9	0.9	0.9	3.6	0.9	0.9	0.9	0.9	3.6
% of adjusted revenue	0.3%	0.5%	0.2%	0.2%	0.1%	0.2%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Total Operating Expenses	1,283.8	400.7	446.8	447.2	502.9	1,797.6	628.8	619.8	730.7	777.8	2,757.1	746.2	843.8	912.4	949.1	3,451.5	945.8	1,077.9	1,129.6	1,171.4	4,324.8
% of adjusted revenue	89%	91%	86%	80%	83%	84%	102%	91%	90%	89%	92%	82%	83%	84%	82%	83%	78%	78%	77%	75%	77%
Operating Income (loss)	(16.2)	(15.4)	5.8	40.2	19.8	50.3	(90.3)	(23.1)	(11.6)	(0.3)	(125.3)	64.1	58.2	49.4	78.1	249.8	135.1	147.3	173.4	217.5	673.2
% of adjusted revenue	(1%)	(3%)	1%	7%	3%	2%	(15%)	(3%)	(1%)	(0%)	(4%)	7%	6%	5%	7%	6%	11%	11%	12%	14%	12%
Adjusted Operating	192.6	43.1	81.8	113.9	100.4	339.1	(13.0)	73.1	79.6	96.1	235.9	155.3	171.7	157.2	191.8	675.9	240.0	277.8	297.3	348.3	1163.3
% of adjusted revenue	13%	10%	16%	20%	17%	16%	-2%	11%	10%	11%	8%	17%	17%	15%	17%	16%	20%	20%	20%	22%	21%
Interest (income) & expense	17.2	4.7	5.1	5.6	6.1	21.5	9.2	14.8	14.8	14.8	53.5	14.8	14.8	14.8	14.8	59.1	14.8	14.8	14.8	14.8	59.1
Other (income) & expense	(17.7)	11.3	1.2	(5.5)	(6.7)	0.3	5.9	(25.6)	0.0	0.0	(19.7)	3.5	3.5	3.5	3.5	13.9	3.5	3.5	3.5	3.5	13.9
Pretax Income (loss)	(15.7)	(31.4)	(0.598)	40.1	20.4	28.5	(105.4)	(12.2)	(26.4)	(15.1)	(159.0)	45.8	39.9	31.2	59.8	176.8	116.8	129.0	155.1	199.2	600.2
Adjusted Pretax Income (loss)	193.1	27.1	75.4	113.8	101.0	317.3	(28.1)	83.9	64.9	81.3	202.1	137.1	153.4	138.9	173.5	602.9	221.7	259.5	279.0	330.0	1,090.2
Taxes (benefit)	2.3	0.1	(0.5)	2.6	0.5	2.8	0.5	(0.8)	2.0	2.0	3.8	2.0	2.0	2.0	2.0	8.0	2.0	2.0	2.0	2.0	8.0
Adjusted Net Income	237.9	59.1	103.6	126.4	113.9	402.9	(8.7)	90.7	78.9	95.3	256.2	145.5	161.9	147.4	182.0	636.8	230.2	268.0	287.5	338.5	1,124.2
Adjusted EPS	\$0.50	\$0.12	\$0.21	\$0.26	\$0.23	\$0.83	(\$0.02)	\$0.18	\$0.16	\$0.19	\$0.51	\$0.29	\$0.32	\$0.29	\$0.35	\$1.24	\$0.44	\$0.51	\$0.55	\$0.64	\$2.14
S/O - Diluted (Adjusted)	479	487	487	486	485	486	485	500	503	506	499	509	512	515	518	514	521	524	527	530	526
Adjusted EBITDA	266.6	65.0	107.5	134.8	120.6	428.0	9.3	97.9	100.2	118.0	325.5	177.9	194.9	179.3	215.4	767.5	264.3	302.8	321.2	373.8	1,262.1
% of adjusted revenue	18.5%	14.7%	20.7%	24.0%	19.9%	20.1%	1.5%	14.5%	12.3%	13.4%	10.9%	19.6%	19.2%	16.6%	18.6%	18.5%	21.8%	22.0%	22.0%	23.9%	22.5%
q/q change	4.4%	(5.6%)	6.0%	3.3%	(4.1%)	1.6%	(18.4%)	12.9%	(2.1%)	1.1%	(9.2%)	6.1%	(0.3%)	(2.6%)	2.0%	7.5%	3.1%	0.2%	(0.0%)	2.0%	4.0%

Source: Company data and RBC Capital Markets estimates

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## Required disclosures

### Conflicts disclosures

The analyst(s) responsible for preparing this research report received compensation that is based upon various factors, including total revenues of the member companies of RBC Capital Markets and its affiliates, a portion of which are or have been generated by investment banking activities of the member companies of RBC Capital Markets and its affiliates.

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RBC Capital Markets, LLC makes a market in the securities of Square, Inc..

### Explanation of RBC Capital Markets Equity rating system

An analyst's 'sector' is the universe of companies for which the analyst provides research coverage. Accordingly, the rating assigned to a particular stock represents solely the analyst's view of how that stock will perform over the next 12 months relative to the analyst's sector average.

#### Ratings

**Outperform (O):** Expected to materially outperform sector average over 12 months.

**Sector Perform (SP):** Returns expected to be in line with sector average over 12 months.

**Underperform (U):** Returns expected to be materially below sector average over 12 months.

**Restricted (R):** RBC policy precludes certain types of communications, including an investment recommendation, when RBC is acting as an advisor in certain merger or other strategic transactions and in certain other circumstances.

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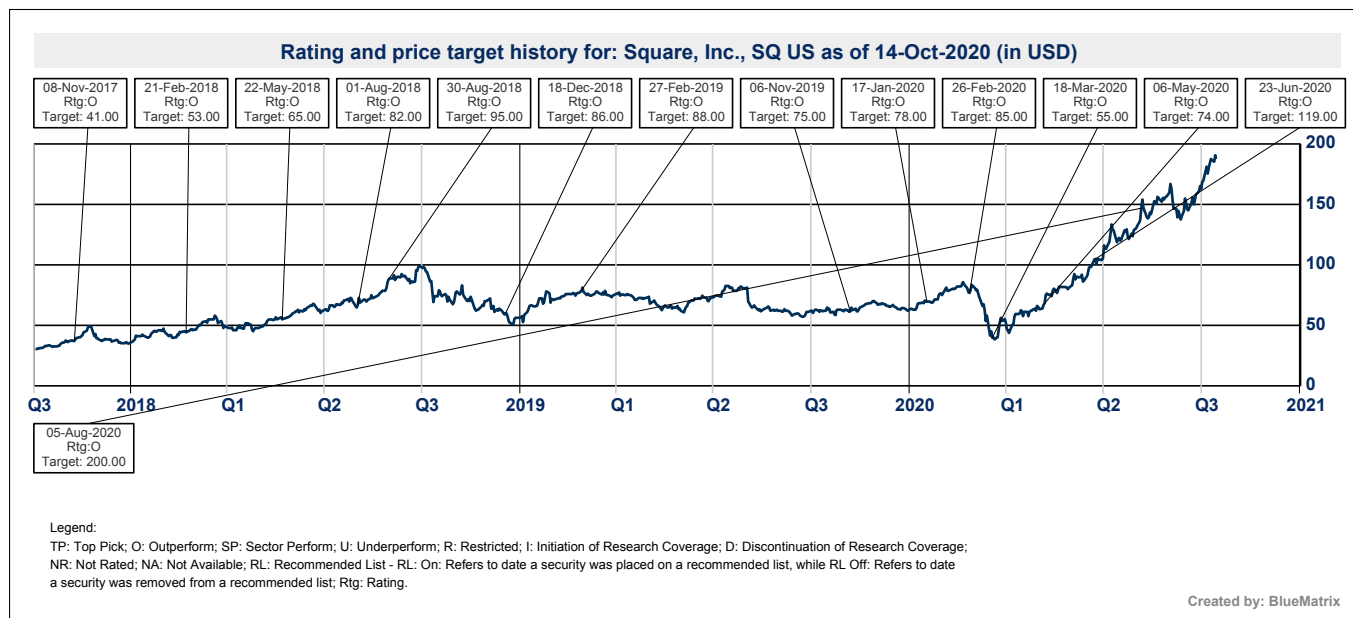
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Distribution of ratings				
RBC Capital Markets, Equity Research				
As of 30-Sep-2020				
Rating	Count	Percent	Investment Banking Serv./Past 12 Mos.	
			Count	Percent
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HOLD [Sector Perform]	619	41.60	135	21.81
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References to a Recommended List in the recommendation history chart may include one or more recommended lists or model portfolios maintained by RBC Wealth Management or one of its affiliates. RBC Wealth Management recommended lists include the Guided Portfolio: Prime Income (RL 6), the Guided Portfolio: Dividend Growth (RL 8), the Guided Portfolio: ADR (RL 10), and the Guided Portfolio: All Cap Growth (RL 12). RBC Capital Markets recommended lists include the Strategy Focus List and the Fundamental Equity Weightings (FEW) portfolios. The abbreviation 'RL On' means the date a security was placed on a Recommended List. The abbreviation 'RL Off' means the date a security was removed from a Recommended List.

## Equity valuation and risks

For valuation methods used to determine, and risks that may impede achievement of, price targets for covered companies, please see the most recent company-specific research report at <https://www.rbcinsightresearch.com> or send a request to RBC Capital Markets Research Publishing, P.O. Box 50, 200 Bay Street, Royal Bank Plaza, 29th Floor, South Tower, Toronto, Ontario M5J 2W7.

### Square, Inc.

#### Valuation

Our price target is \$240 or 21x CY22E EV/ adjusted revenue, which is in-line with software/payment peers that generate similar revenue growth but slightly higher than historical averages, given our believe that SQ will emerge as a structural winner post the currently challenged macro environment. This target supports our Outperform rating.

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## Conflicts policy

RBC Capital Markets Policy for Managing Conflicts of Interest in Relation to Investment Research is available from us on request. To access our current policy, clients should refer to





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## Dissemination of research and short-term trade ideas

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