13 August 2020 | United States

EQUITIES

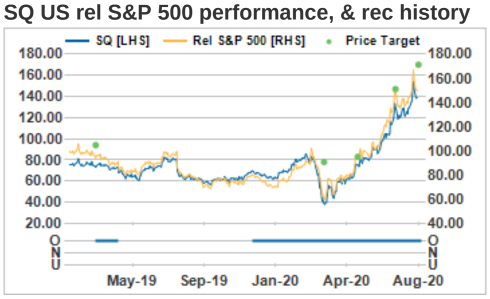
Square (SQ US)
The path to ubiquity

SQ US		Outperform
Price (at 04:00, 13 Aug 2020 GMT)		US$139.02
Valuation	US$	170.00
- DCF (WACC 9.3%, beta 1.7, ERP 5.2%, RFR 0.6%, TGR 3.5%)		
12-month target	US$	170.00
12-month TSR	%	+22.3
GICS sector		Software & Services
Market cap	US$m	61,667
30-day avg turnover	US$m	1,652.4
Number shares on issue	m	443.6

Investment fundamentals

Year end 31 Dec		2019A	2020E	2021E	2022E
Revenue	m	4,714	7,795	9,997	11,920
EBITDA	m	417	413	766	1,082
EBIT	m	333	316	640	920
Adjusted profit	m	387	355	657	933
Gross cashflow	m	462	449	783	1,095
EPS adj	US$	0.80	0.70	1.30	1.86
EPS adj growth	%	69.8	-12.0	85.9	43.1
PER adj	x	174.8	198.7	106.9	74.7
EV/EBITDA	x	161.3	170.3	91.3	64.0
Net debt/equity	%	-8.6	23.2	6.5	-10.7

SQ US rel S&P 500 performance, & rec history



Note: Recommendation timeline - if not a continuous line, then there was no Macquarie coverage at the time or there was an embargo period.
Source: FactSet, Macquarie Research, August 2020
(all figures in USD unless noted)

Key points

- Seller business has proven to be resilient with a solid path of profitability ahead.
- Square could open synergies between the 2 ecosystems by venturing into ERP.
- Lifting ests on growth trajectory + revenue yield. Increase TP from $147 to $170.

Event

- Following Square's Q2 reporting last week, we take a deeper look at the revenue yields in the Seller business and the potential roadmap ahead for integrating Seller and Cash App as it relates to enterprise resource planning.

Impact

- **Seller.** Management highlighted resiliency in the Seller business, which had low expectations amid pandemic-related macro concerns. They pointed to strong adoption of omnichannel products (online channels +50% YoY to now >25% of Seller GPV) with 1 in 3 Online Store sellers onboarded in Q2 being new to Square, and higher monetization from new seller cohorts in the 5 weeks after onboarding compared to those onboarded last year over the same period. Even with headwinds of pausing new core flex loans, waiving April software and other relief benefits, we found the Seller gross profit take rate to be particularly impressive, coming in at 0.33% (flat YoY but down 7 bps from Q1). We estimate that without the voluntary relief actions, GP take rate could have increased by ~10 bps.
- **Looking beyond the numbers.** We see a large opportunity on the merchant front to consolidate services across longstanding components of the business ops support infrastructure. Square has been building its suite of service offerings for sellers beyond just transaction processing (Square Card, SMB loans, inventory, payroll, employee benefits, marketing, analytics & further opportunities with a banking license), which we think would allow Square to make a run at the entirety of ERP offerings including finance/accounting, as opposed to just allowing synching with partnered platforms. Some existing players in this field are also broadening their services and moving towards SMB management offerings, but Square has the benefit of a two-sided network, strong network effects from P2P/Cash App, and unique Boost offerings. The individual consumer angle compounds the value and versatility of Square's business infrastructure for employees and proprietors, and merchants and employees alike would see added flexibility from staying within Square's ecosystem for settlement and flexibility.

Earnings and target price revision

- We increase our FY20/21/22 EPS ests to $0.70/1.30/1.86 from $0.34/1.12/1.65 previously. Our TP increases to $170 from $147 based on our DCF valuation.

Price catalyst

- 12-month price target: US$170.00 based on a DCF methodology.
- Catalyst: Stimulus package, business reopening timelines, banking license.

Action and recommendation

- **Outperform.** Cash App continues to impress, but the resilience of the Seller business should not be overlooked. We like the approach that Square is taking in helping its Seller base during this time to build goodwill and deepen relationships to drive growth down the line. This also sets Square up to venture deeper into ERP services with the unique angle of having strong network effects from Cash App.

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Earnings recap and performance highlights

Square reported Q2 results last week and provided an update on July metrics – all of which were impressive, with results exceeding the loftiest of expectations. As has been recapped extensively by the Street at this point, the highlights included:

⇒ Cash App gross profit up 167% in the period, now boasting 30m monthly active users yielding a $45 ARPU, and funds held with Cash App jumped 86% QoQ.

⇒ Cash Card is up to 7m users (doubling YoY) and seeing a 50% sequential jump in volumes and monthly transactions per card at 15x on average (every other day).

⇒ Bitcoin revenues came in well above expectations at $876m vs. consensus $278m.

⇒ Despite COVID, Q2 adj. EBITDA margins came in at 5.1%, well ahead of consensus 0.5%.

⇒ GPV of $22.8bn was over $4bn higher than consensus for the quarter.

⇒ July Cash App gross profit growth is up 200% YoY. Seller GPV is up 5% in July after being down 30% in the core lockdown timeframe (April), and card not present continues to outperform card present.

⇒ Q3 SG&A should see an extra $100m investment likely for Cash App marketing.

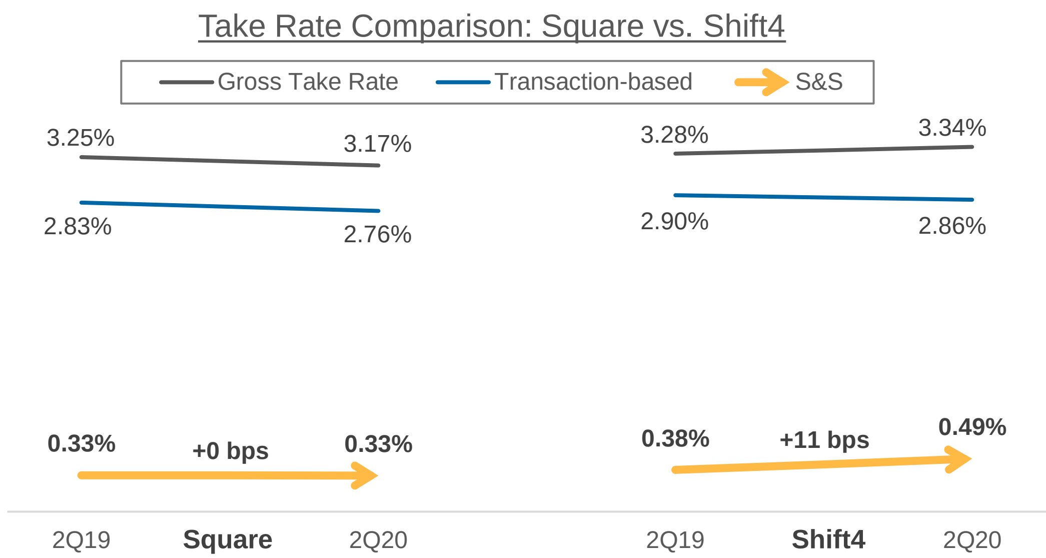
Seller's GPV better than feared

While the strength in Cash App numbers has certainly been impressive, we find resilience in the Seller business over Q2 to be even more notable. Seller had low expectations given Square's GPV mix being skewed towards industries heavily impacted by the pandemic (i.e. 26% Food and Drink, 17% Retail, 11% Beauty & Personal Care as of FY19). After reporting GPV down 39% YoY in April in a business update, Square followed that up with strong improvements in May and June in Q2 to end up down just 15% (CP down 38%; CNP up 16%). This was followed by solid July numbers with Seller GPV increasing 5% YoY (CP down 4%; CNP up 26%).

We originally thought that the outperformance in CNP volumes was largely due to Square's large base of brick-and-mortar sellers, but we found management's comments that "one in three Online Store sellers onboarded in the second quarter were new to Square" to be particularly promising. In our view, this suggests Square ranks highly in merchants' minds when it comes to eCommerce solutions, a function of management's ability to integrate the Weebly acquisition from two years ago. Additionally, management should be credited for their timely response to the stimulus opportunity in facilitating PPP loans to help underserved sellers keep employees on the payroll – this is on top of Square waiving April software subscription fees and providing sellers the option to pause paid subscriptions for up to three months, beginning in May.

Management noted that cohorts of new Square sellers generated more gross profit in their first 5 weeks after onboarding compared to seller cohorts who joined the platform during the same period a year ago. Even with the headwinds from PPP loans generating lower revenue compared to flex loans (new originations halted during Q2) and other favorable benefits provided to sellers in addition to those mentioned above (i.e. reducing price of contactless hardware by 20% in mid-May, launching "freemium" solutions for Square for Restaurants and Square for Retail), the Seller business still generated a take rate (net of hardware) of 3.09% (down 8bps from 2Q19) with Seller S&S take rate as a percentage of gross revenue at 0.33% (flat YoY; down 7bps QoQ) and a gross profit take rate of 1.30% (up 8 bps YoY; flat QoQ). To put this performance in perspective, we compare take rates at Square's Seller business against those at competitor Shift4's:

Fig 1 Square provided numerous temporary relief benefits to its sellers in Q2, limiting its S&S take rates. In contrast, S&S take rates at competitor Shift4 improved 11 bps YoY, which shows the potential room for profitability improvement in Square's Seller business once relief benefits to sellers are lifted.



Source: Company filings, Macquarie Research, August 2020.
Note: Shift4 rates are based on gross, payment-based, and subscription & other revenues vs. end-to-end payment volume.

Payment-based take rates at Shift4 improved 11 bps YoY to 0.49% in Q2, while S&S take rates at Square remained flat YoY. However, we note that Square generated an S&S take rate of 0.40% in Q1. This shows Square sacrificing short-term profitability during the pandemic to build goodwill and deepen relationships with its seller base. Had Square not provided these relief benefits and continued to originate new core flex loans at Square Capital, we estimate the S&S take rate could have improved by ~10 bps, flowing through to gross profit with even more upside potential upside as sellers continue to utilize more software subscriptions, instant transfers, Square Card and other products.

Looking beyond the numbers

As we look out over the next few years and attempt to estimate what Square's growth trajectory could look like, we focus on broader utilization, heightened rate of adoption, and structural changes to the economy and lifestyles. These all give us added confidence in the potential for a trajectory beyond what was factored in just a few months ago and what the Street is factoring in now. Below we go through various categories we think are prime for Square to disintermediate, we start with sellers and the potential to consolidate services across longstanding components of the business ops support infrastructure.

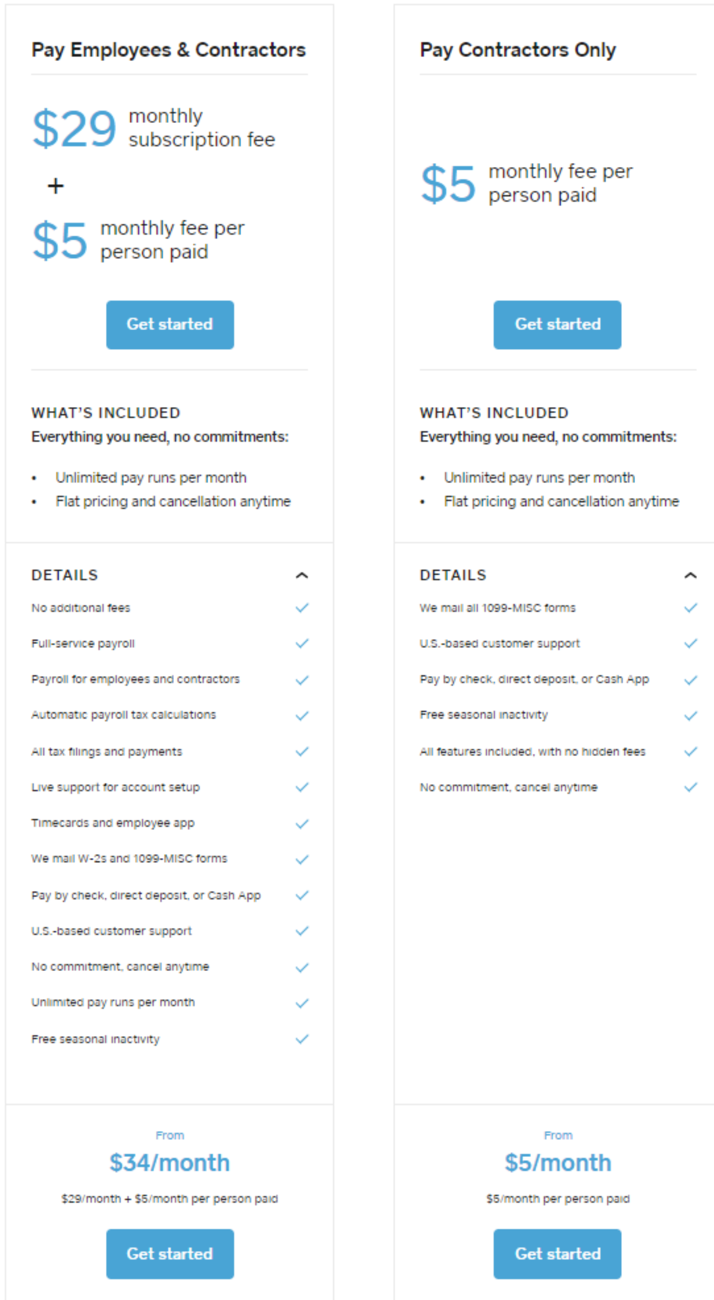
Owning POS and direct deposit, next payroll, so why not all ERP?

Management commented on how at the start of March, only 1/12th of sellers were cashless, compared to June when the proportion reached 1/4th. As reliance on the seller platform and virtual terminals grows, we expect Square to lean into its opportunity to facilitate more small business infrastructure in-house vs. the current synching capabilities the platform currently leverages. Funds deposited into seller accounts held with Square can then be spent as needed via the Square Card (debit), and SMB loans through Square Capital can be repaid on a flexible basis based on the strength and seasonality of transactions made through a seller's merchant account with payment seamlessly applied through the transaction batch processing itself. This kind of integration is likely to spur an even greater shift to cashless as SMBs rely more heavily on Square Capital for liquidity and therefore increasing digital volumes to underpin loan repayments.

Payroll. As Square continues to enable seamless integration of business operations through seller accounts and transaction volumes/interchange, the reinforcing flywheel continues to compound, for example with payroll. Square offers a payroll solution that runs timecard integration, processes tax withholding, manages employee benefits, and of course, processes direct deposit through Cash App, or even paper checks as part of the offering. The services go so far as to even offer workers' comp insurance for businesses. All of this is done for a flat monthly platform fee and recipient fee. And while other platforms (like Stripe) have similar offerings, it's the P2P Cash App network component and debit reward benefits through Boost that differentiate Square from the rest of the competition.

Cash App versatility makes all the difference. The individual consumer angle compounds the value and versatility of Square's business infrastructure for employees and proprietors. If both the merchant and the employees have a preference for instant settlement into personal accounts, and any fee synergies Square may provide for bundling, not to mention the added benefit of Boost cash back for Cash App users, the growth in Square's penetration in this space could be immense, especially considering the already consolidated marketplace across ADP, Paychex, and QuickBooks, which leads us to our next point.

Fig 2 Square already offers integrated payroll processing within its Seller platform, further incentivizing Cash App for employees and business owners – additional flywheel momentum.



Source: squareup.com, August 2020

Opportunity on ERP from the consumer angle

With Cash App leading the way, merchants and employees alike will see added flexibility from staying within the Square ecosystem, and with the flexibility of integrated payroll and personnel management, we don't see why Square wouldn't make a run at the entirety of ERP (enterprise resource planning) as opposed to simply synching with outside partners. Stripe and others already offer invoicing functionalities through their platforms, but as of yet don't have the consumer-facing ubiquity that Cash App is on the path to achieving.

Square's platform is already able to consolidate HR-type services, customer retention via the marketing offering, purchasing, etc. But it's the finance and accounting piece in combination with the data and analytics modules, that when coupled with Square Capital could offer a cohesive SMB-ideal alternative to the Intuits of the world, and the customer data management that might be an alternative to more established offerings in the marketplace. Plus, should Square get a full banking license, further integration across merchant financials, employee cash flow, business growth visibility, and income vs. expenses at both the enterprise and individual level, would facilitate the offering of other services like mortgages and consumer credit which are currently offered by other players in the space but would incentivize reliance on Square for the entire spectrum of SMB management needs.

Updating our estimates

We update our estimates with GPV and profitability holding up better than expected. We now model GPV growth in FY20 to be positive at +4% YoY to $111bn, followed by 29% growth to $143bn in FY21, and then 25% growth in FY22. We also increase our net revenue yield assumptions to reflect increased engagement and product adoption from both Cash App and Seller platforms. We model adj. EBITDA for FY20 to come in slightly below FY19 levels given the increased investments around S&M, with EBITDA margins expanding from 13.8% in FY20 to 18.9% and 20.8% in FY21 and FY22, respectively. Our FY20/21/22 EPS estimates increase to $0.70/1.30/1.86 from $0.34/1.12/1.65 previously.

We continue to model Square on a consolidated basis for transaction-based and S&S revenue, and plan to break out separate segment reporting once more information becomes available.

Fig 3 Square P&L

Square: Annual Income Statement 2015-2021E (in $mn)

$mn except per share data,	CY 15	CY 16	CY 17	CY 18	CY 19	CY 20E	CY 21E	CY 22E
Total Net Revenue	n/m	n/m	n/m	3,298.2	4,713.5	7,794.9	9,996.7	11,919.9
Adj. Net Revenue	452.2	686.6	984.0	1,587.6	2,275.7	3,003.5	4,042.5	5,215.8
% Growth	*63.6%*	*51.9%*	*43.3%*	*61.4%*	*43.3%*	*32.0%*	*34.6%*	*29.0%*
Opex	461.9	559.8	737.7	1,123.8	1,565.6	2,333.4	2,972.4	3,785.2
% of Adj. Net Rev.	*102.2%*	*81.5%*	*75.0%*	*70.8%*	*68.8%*	*77.7%*	*73.5%*	*72.6%*
Adj. EBIT	(68.7)	7.1	101.7	192.9	332.7	315.8	640.0	920.3
% OM	*-15.2%*	*1.0%*	*10.3%*	*12.1%*	*14.6%*	*10.5%*	*15.8%*	*17.6%*
Income Pre-Tax	(62.9)	16.9	115.1	226.7	384.4	346.0	664.3	945.9
Tax	3.7	1.9	0.1	2.3	2.8	(2.5)	13.3	18.9
Net Income								
Reported	(212.0)	(171.6)	(62.8)	(38.5)	22.8	(73.7)	158.9	344.7
Recurring	(66.6)	15.0	115.0	225.6	386.8	354.6	657.3	933.3
Diluted EPS								
Recurring	(0.39)	0.04	0.27	0.47	0.80	0.73	1.30	1.86
% Growth	*n/m*	*n/m*	*n/m*	*74.8%*	*68.8%*	*-8.4%*	*78.5%*	*43.1%*
Adj. EBITDA	(41.1)	44.9	139.0	256.5	416.9	413.5	765.6	1,082.4
% Margin	*-9.1%*	*6.5%*	*14.1%*	*16.2%*	*18.3%*	*13.8%*	*18.9%*	*20.8%*

Source: Company filings, Macquarie Research, August 2020

Valuation

Our TP increases from $147 to $170 based on our DCF valuation. The increase is primarily driven by Seller GPV holding up better than expected so far, more users and increased engagement and adoption of products on both Seller and Cash App platforms, and stronger growth from a large increase in investment spending.

Fig 4 Square DCF Valuation

Square DCF Analysis ($mn)

	FY19	FY20E	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E	FY29E
Total Adj. Revenues	2,276	3,004	4,042	5,216	6,649	8,372	10,413	12,790	15,511	18,570	21,946
% Organic Growth - ex. Caviar		*41%*	*35%*	*29%*	*27%*	*26%*	*24%*	*23%*	*21%*	*20%*	*18%*
Adj. EBITDA	417	413	766	1,082	1,563	2,198	3,020	4,061	5,352	6,918	8,779
% Adj. EBITDA Margin	*18.3%*	*13.8%*	*18.9%*	*20.8%*	*23.5%*	*26.3%*	*29.0%*	*31.8%*	*34.5%*	*37.3%*	*40.0%*
Growth (bps)	216	(455)	517	181	275	275	275	275	275	275	275
D&A	76	94	126	162	206	258	320	392	474	566	666
% of Sales	*3.3%*	*3.1%*	*3.1%*	*3.1%*	*3.1%*	*3.1%*	*3.1%*	*3.1%*	*3.1%*	*3.0%*	*3.0%*
EBIT	333	316	640	920	1,357	1,939	2,700	3,669	4,877	6,352	8,112
% of Sales	*14.6%*	*10.5%*	*15.8%*	*17.6%*	*20.4%*	*23.2%*	*25.9%*	*28.7%*	*31.4%*	*34.2%*	*37.0%*
Tax Rate	*0.7%*	*-0.7%*	*2.0%*	*2.0%*	*3.0%*	*4.0%*	*5.0%*	*6.0%*	*7.0%*	*8.0%*	*9.0%*
NOPAT	330	318	627	902	1,316	1,862	2,565	3,449	4,536	5,844	7,382
+ D&A	76	94	126	162	206	258	320	392	474	566	666
+ Chg.in Working Capital	(105)	(1,535)	(417)	(466)	(547)	(633)	(725)	(819)	(914)	(1,007)	(1,094)
% of Sales	*-4.6%*	*-51.1%*	*-10.3%*	*-8.9%*	*-8.2%*	*-7.6%*	*-7.0%*	*-6.4%*	*-5.9%*	*-5.4%*	*-5.0%*
- CapEx	(62)	(118)	(157)	(202)	(250)	(307)	(371)	(443)	(522)	(607)	(695)
% of Sales	*-2.7%*	*-3.9%*	*-3.9%*	*-3.9%*	*-3.8%*	*-3.7%*	*-3.6%*	*-3.5%*	*-3.4%*	*-3.3%*	*-3.2%*
FCFF	238	(1,241)	178	396	725	1,180	1,789	2,578	3,574	4,796	6,259
% Growth	*64.5%*	*-620.8%*	*-114.4%*	*121.9%*	*83.0%*	*62.8%*	*51.6%*	*44.1%*	*38.6%*	*34.2%*	*30.5%*

Assumptions	
Risk Free	1%
Market Risk Premium	5.2%
Market Rate	6%
Beta	1.7
Cost of Equity	9.4%
Cost of Debt	3.1%
Tax 3-yr avg	2%
AT Cost of Debt	3.1%
Debt / Capital @ MV	1.5%
WACC	9.3%
Terminal Growth Rate	3.5%

Discounted Cash Flow Calculation	
NPV FCFF	9,524
TV	141,763
PV of TV	63,878
Implied EV	73,402
Net Debt	(249)
Implied MV	73,651
Shares	434.9
Implied Price	170
Current Price	142
% Upside / (Downside)	20%

SQUARE

Source: Company filings, Macquarie Research, August 2020

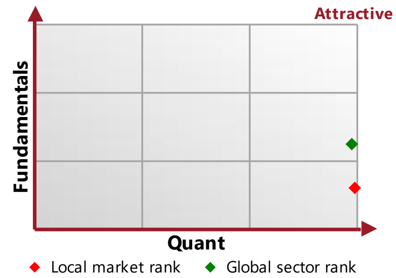
Macquarie Quant Alpha Model Views

The quant model currently holds a strong positive view on Square. The strongest style exposure is Price Momentum, indicating this stock has had strong medium to long term returns which often persist into the future. The weakest style exposure is Profitability, indicating this stock is not efficiently converting investments to earnings; proxied by ratios like ROE or ROA.

12/676

Global rank in
Software & Services

% of BUY recommendations	38% (15/40)
Number of Price Target downgrades	1
Number of Price Target upgrades	31

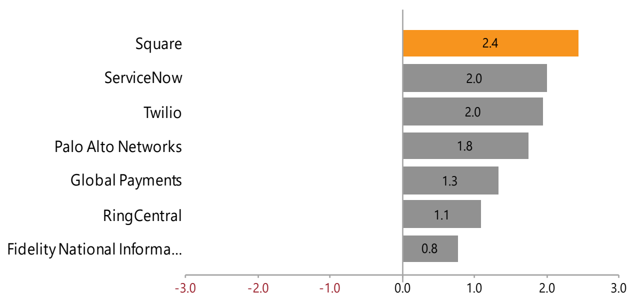


Displays where the company's ranked based on the fundamental consensus Price Target and Macquarie's Quantitative Alpha model.

Two rankings: Local market (United States) and Global sector (Software & Services)

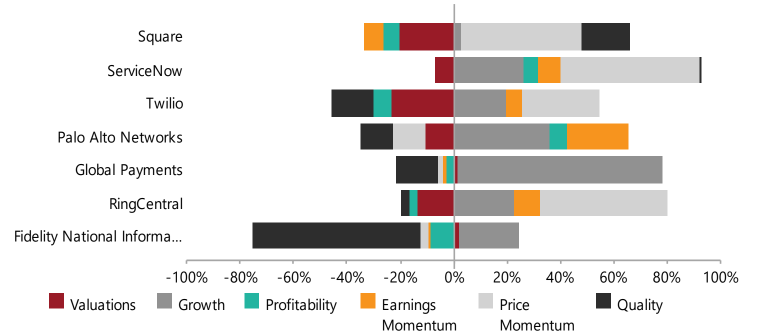
Macquarie Alpha Model ranking

A list of comparable companies and their Macquarie Alpha model score (higher is better).



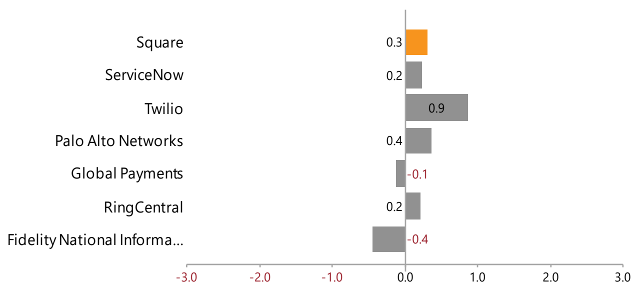
Factors driving the Alpha Model

For the comparable firms this chart shows the key underlying styles and their contribution to the current overall Alpha score.



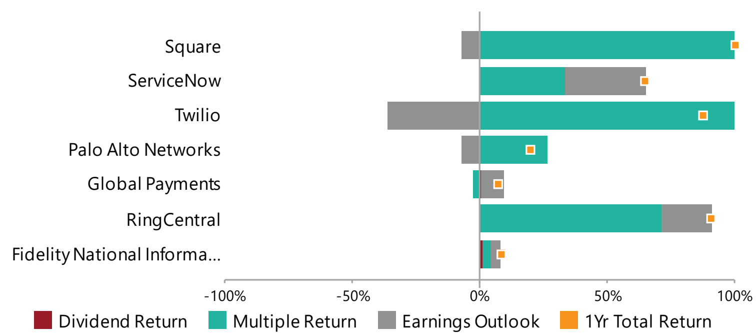
Macquarie Earnings Sentiment Indicator

The Macquarie Sentiment Indicator is an enhanced earnings revisions signal that favours analysts who have more timely and higher conviction revisions. Current score shown below.



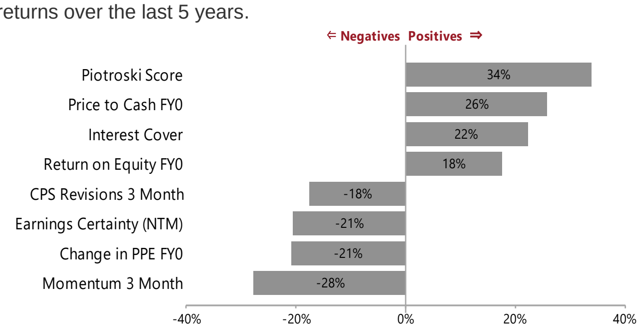
Drivers of Stock Return

Breakdown of 1 year total return (local currency) into returns from dividends, changes in forward earnings estimates and the resulting change in earnings multiple.



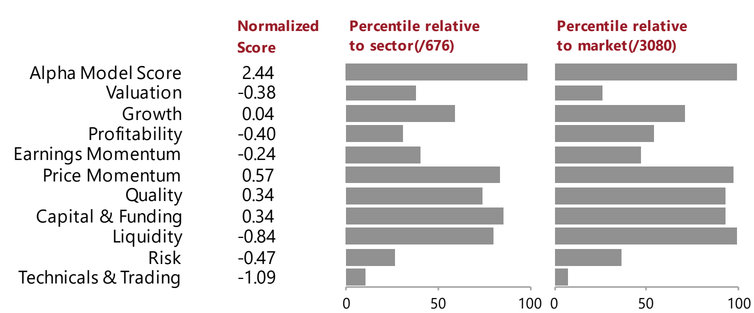
What drove this Company in the last 5 years

Which factor score has had the greatest correlation with the company's returns over the last 5 years.



How it looks on the Alpha model

A more granular view of the underlying style scores that drive the alpha (higher is better) and the percentile rank relative to the sector and market.



Source (all charts): FactSet, Thomson Reuters, and Macquarie Quant. For more details on the Macquarie Alpha model or for more customised analysis and screens, please contact the Macquarie Global Quantitative/Custom Products Group (cpg@macquarie.com)

Important disclosures:

Recommendation definitions

Macquarie – Asia and USA
Outperform – expected return >10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie – Australia/New Zealand
Outperform – expected return >10%
Neutral – expected return from 0% to 10%
Underperform – expected return <0%

Note: expected return is reflective of a Medium Volatility stock and should be assumed to adjust proportionately with volatility risk

Volatility index definition*

This is calculated from the volatility of historical price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.
* Applicable to select stocks in Asia/Australia/NZ

Recommendations – 12 months
Note: Quant recommendations may differ from Fundamental Analyst recommendations

Financial definitions

All "Adjusted" data items have had the following adjustments made:
Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

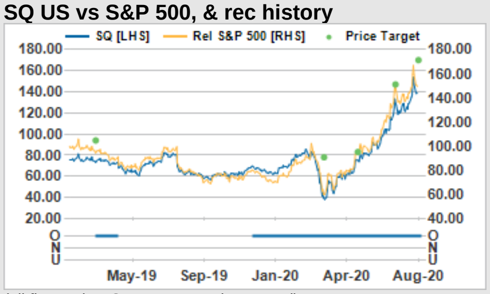
EPS = adjusted net profit / efpowa*
ROA = adjusted ebit / average total assets
ROA Banks/Insurance = adjusted net profit /average total assets
ROE = adjusted net profit / average shareholders funds
Gross cashflow = adjusted net profit + depreciation
*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

Recommendation proportions – For quarter ending 30 June 2020

	AU/NZ	Asia	USA	
Outperform	49.82%	60.45%	66.29%	(for global coverage by Macquarie, 4.18% of stocks followed are investment banking clients)
Neutral	35.09%	23.46%	33.71%	(for global coverage by Macquarie, 4.41% of stocks followed are investment banking clients)
Underperform	15.09%	16.09%	0.00%	(for global coverage by Macquarie, 3.21% of stocks followed are investment banking clients)

SQ US vs S&P 500, & rec history



(all figures in USD currency unless noted)

Note: Recommendation timeline – if not a continuous line, then there was no Macquarie coverage at the time or there was an embargo period.
Source: FactSet, Macquarie Research, August 2020

12-month target price methodology

SQ US: US$170.00 based on a DCF methodology

Company-specific disclosures:

Important disclosure information regarding the subject companies covered in this report is available publicly at www.macquarie.com/research/disclosures. Clients receiving this report can additionally access previous recommendations (from the year prior to publication of this report) issued by this report's author at https://www.macquarieinsights.com.

Date	Stock Code (BBG code)	Recommendation	Target Price
09-Jul-2020	SQ US	Outperform	US$147.00
11-May-2020	SQ US	Outperform	US$83.00
19-Mar-2020	SQ US	Outperform	US$78.00
27-Mar-2019	SQ US	Outperform	US$94.00

Target price risk disclosures:
SQ US: Key downside risks include failure to acquire sufficient customers, increased competition, attrition and inability to cross-sell software and services.

Sensitivity analysis:
Clients receiving this report can request access to a model which allows for further in-depth analysis of the assumptions used, and recommendations made, by the author relating to the subject companies covered. To request access please contact insights@macquarie.com.

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