



# Square

## **Square Thought Paper**

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INST 620 - Introduction to Strategic Management

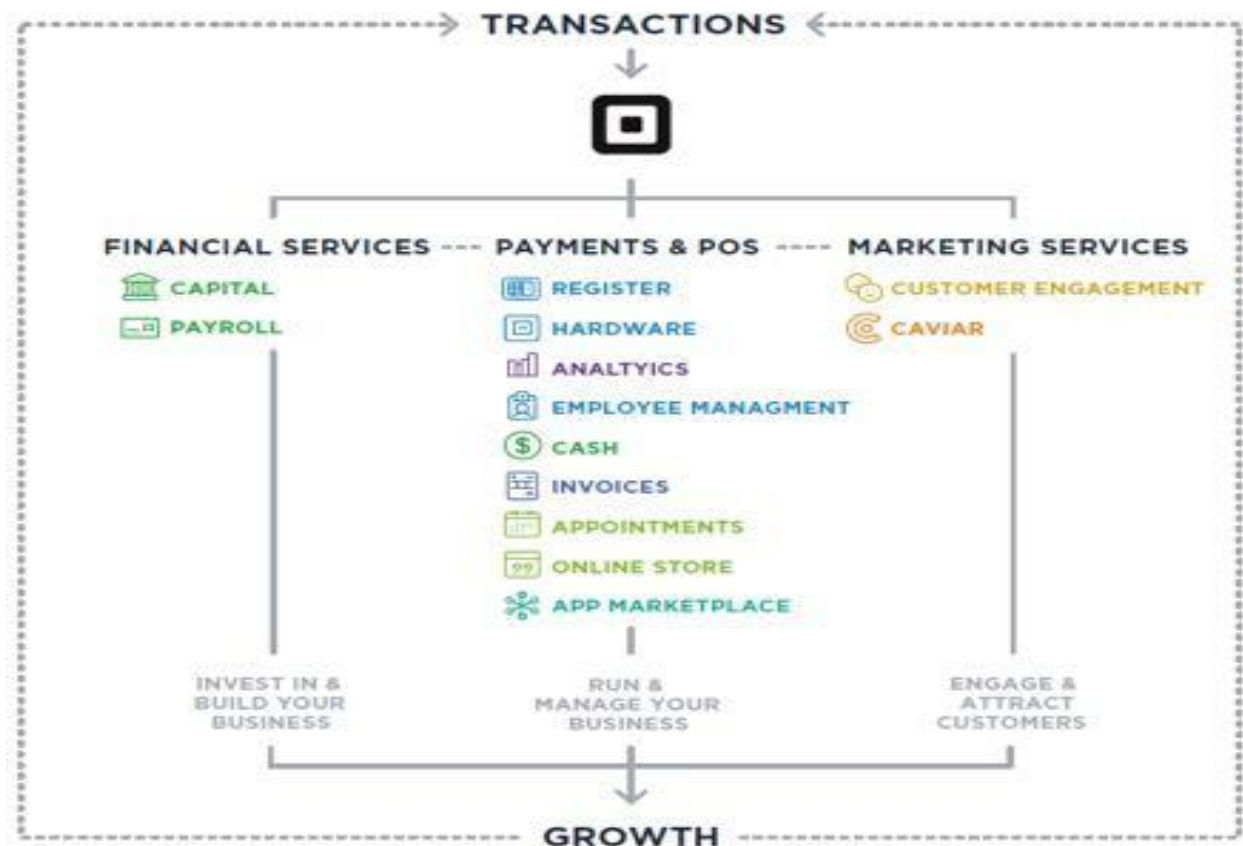
Year 2030. I go to a mall for shopping. I enter the apparel store of a huge brand, browse through the infinite collection of clothes that they have, select a few jeans and t-shirts, scan them for checkout and walk out of the store, knowing that the purchase has been paid for via my digital wallet. No long waiting lines for billing, no swiping of card or handling currency change, no hassles at all. This is how the future will look like in a cashless economy. And we are almost there, thanks to companies like **Square** who are leading the way into this new digital economy. I can envision a day when my grandchildren will ask me what paper currency looked like. Even today I feel a little strange using actual cash to make a purchase. Why are we still passing around these wrinkled pieces of paper when the entire financial system is electronic? It's not as if our bank has a stack of cash waiting in a vault with our name on it. Money is transferred in and out of our bank accounts as a string of ones and zeros. Why should our transactions at the mall be any different? Cash equals hassle. We have to go to an ATM to get it. A store has to count it, stash it in an envelope and lug it down to the bank to deposit it (Roos, 2013). Debit and credit cards need to be swiped, and this involves using specialized hardware on the merchant side. Why not go completely cashless? Obviously, there are obstacles to a cashless economy. What about people who don't have bank accounts or credit cards? What about fraud, identity theft and other security concerns? Well, these are topics of discussion for another day.

Look at how far we have come, from the centuries old barter system of exchanging goods, to paying money using plastic cards. A few years back, until the year 2009, small time merchants and businesses were stuck with the problem of not being able to process credit card payments due to expensive hardware and software. As a result of this, they were losing out on business, and were desperate for a solution. Jack Dorsey understood this need and came up with an integrated hardware and software solution – **Square**, that completely reimagined the way small businesses accept payments. The thing that worked in Square's favor was that it was innovative and provided a simple and elegant solution to the existing problem, without being heavy on their target market's pockets. Square's hardware was aesthetically pleasing which sparked interest and curiosity, while its minimalist design and ease of use touched a chord with the small merchants. It had the first mover advantage, since there were no other competitors in the market when Square was launched. Square paved the path for other entrants, who realized that payments processing was still a relatively uncharted territory, and the potential was huge. Square mostly targeted the smaller businesses, and helped them grow by providing a suite of products, in addition to the payment processing hardware and software.

**Square's offerings and Business Model**

Square, which some call “an operating system for small business”, has made available a myriad of tools and devices to help a fledgling one-person business expand without compromising on personalized customer experience. The main reason for Square's success, besides the technology that it provides, is the flat rates that they charge per transaction. There are no activation charges, no monthly charges, no charges for its basic magstripe reader, no statement charges; you only pay for the transactions you do. A flat rate of 2.75% for all swiped transactions, 3.5% + \$0.15 for keyed transactions, and 2.9% + \$0.30 for online transactions(Johnson, 2017). This is unlike most other competitor's offerings and one of the major selling points for Square. Additionally, they provide services like advanced analytics, inventory management, employee management and payroll processing, email and SMS receipts, offline card processing, instant deposits, gift cards, customizable dashboards, email marketing and a host of other services. And the cherry on the cake is the fact that most of these services are free, while a few of them are available at extremely low rates. Which begs the question, how does Square generate revenue? Is it like many other startups that is burning investor's cash just to capture the bulk of the market share before they start charging for the services? What exactly is Square's business model?

## The Square Ecosystem



(Yeung, 2015)

	Year Ended December 31,			Six Months Ended June 30,	
	2012	2013	2014	2014	2015
	(in thousands)			(unaudited)	
<b>Consolidated Statement of Operations Data:</b>					
Revenue:					
Transaction revenue	\$ 193,978	\$ 433,737	\$ 707,799	\$ 309,908	\$ 470,974
Starbucks transaction revenue	9,471	114,456	123,024	56,613	62,867
Software and data product revenue	—	—	12,046	2,289	20,934
Hardware revenue	—	4,240	7,323	3,068	5,795
Total net revenue	203,449	552,433	850,192	371,878	560,570
Cost of revenue:					
Transaction costs	126,351	277,833	450,858	196,076	298,927
Starbucks transaction costs	12,547	139,803	150,955	70,512	77,132
Software and data product costs	—	—	2,973	45	7,230
Hardware costs	—	6,012	18,330	8,365	10,910
Amortization of acquired technology	—	—	1,002	272	1,744
Total cost of revenue	138,898	423,648	624,118	275,270	395,943
Gross profit	64,551	128,785	226,074	96,608	164,627
Operating expenses:					
Product development	46,568	82,864	144,637	65,484	85,432
Sales and marketing	56,648	64,162	112,577	55,790	67,911
General and administrative	36,184	68,942	94,220	44,071	59,923
Transaction and advance losses	10,512	15,329	24,081	10,968	24,835
Amortization of acquired customer assets	—	—	1,050	230	950
Impairment of intangible assets	—	2,430	—	—	—
Total operating expenses	149,912	233,727	376,565	176,543	239,051
Operating loss	(85,361)	(104,942)	(150,491)	(79,935)	(74,424)
Interest (income) and expense	5	(12)	1,058	182	858
Other (income) and expense	(167)	(950)	1,104	(220)	746
Loss before income tax	(85,199)	(103,980)	(152,653)	(79,897)	(76,028)
Provision (benefit) for income taxes	—	513	1,440	(542)	1,570
Net loss	\$ (85,199)	\$ (104,493)	\$ (154,093)	\$ (79,355)	\$ (77,598)

As we can see from the above chart, Square's primary revenue contributor is its Payments Processing business. I believe that they should focus on this area, since they already have the main product and services in place, hence they can maximize their revenue by expanding to newer regions and reaching out to more and more small businesses. Another source of revenue which they had was due to their partnership with Starbucks, which didn't quite work out the way Square had anticipated it to. In 2012, Square had entered into a partnership with Starbucks, wherein Starbucks invested \$25 million in Square, and Square became its exclusive processor of debit and credit card payments for all 7,000-plus stores in the United States. However, this turned out to be a bad deal for Square because, even though Starbucks contributed to Square's sales, its transaction processing costs turned out to be more than the revenue Square was able to generate from this deal. Eventually, they had to terminate the agreement early. Another service which they provide is Square Capital, via which they provide loans to small businesses to help them grow and expand their operations. Since Square already has enough data about these businesses owing to their everyday transactions, Square can make informed decisions about the businesses it can fund, and recover these loans by taking a small cut from the everyday transactions. As we can see, the company is not yet profitable. Even though its metrics show consistent growth, they cannot bank only on their payments processing business to drive them to profitability; they need to generate additional revenue streams to convert that last row from 'Net loss' to 'Net gain'.

## Complaints

Just like any other fast growing company, along with the glowing reviews, Square has had its fair share of complaints and negative reviews on the web. A quick Google search will highlight a common theme to the complaints that relate to Square's merchant services, and they boil down to two closely related issues:

**Poor customer support:** This is the number one complaint lodged against Square. Some Square merchants even go so far as to suggest that Square is a scam because of their appalling track record of processing funds that have been placed on hold. Square support indicates that they will respond to email inquiries within 24 hours. The time frame is sometimes closer to 2-3 days according to a slew of frustrated merchant reports. Also, its customer service is mainly automated and involves going through videos, FAQs or dropping a mail to resolve a conflict. They do have an online chat assistant, however the lack of live phone support to address your issues and concerns can turn out to be a big negative, especially for small customers who like to be assured personally rather than via an email or on chat.

**Account stability issues/funding holds:** Difficulty with inaccessible funds is a close second in the complaints department, and considering many of the support complaints are about funding holds, this is probably the most important issue. Square's aggressive fraud prevention tactics have put many small businesses in a position where they can't access their income because their transactions have raised a general red flag for any number of reasons.

## **Competition**

When Square entered the market, it was the only one in this space, but since then competition has increased significantly. Clover Go, Paypal Here, Intuit GoPayment, SparkPay are a just a few of the names that are challenging Square's presence in the market. Dedicated merchant accounts, better rates, better customer service are a few parameters on the basis of which these companies have an upper hand. Since most of these players cater to different market segments ranging from small businesses to midsize ones, Square need to direct its focus on the small business segment and continue offering value via innovation. They also need to bolster their customer support since that is one area where almost all of the competition is better. I understand that they are trying to keep their operational costs low by eliminating live phone support, but they need to make sure that it does not prove to be their Achille's heel in the future.

## **Future Scope**

Currently Square operates in a limited number of countries. They should try to expand globally and be the torchbearers for the digital economy. Specially in countries like India, where the government is pushing for demonetization, the time is ripe for Square to make an entry. Currently the Indian market is flooded with local players like Paytm, Airtel Money, Freecharge and many more. Even the major banks are coming up with their own digital wallets to take advantage of the changing economy. With a name like Jack Dorsey as the founder, I don't believe it should be difficult for Square to raise funding in India and other Asian markets. However, the Indian market is quite different from the US market. Square will have to do a good amount of research on how people transact before they can enter this market. Since majority of the transactions still take place using paper currency, Square will have to come up with promotions to encourage people to start using digital wallets. Also, they will have to redesign many of their products to tailor the Indian market for e.g. Very few merchants in India use tablets for payment processing. Agreed the barriers to entry are many, however as the saying goes, nothing ventured, nothing gained right.

Square could also venture into providing users with hybrid wallets – a combination of regular wallets that hold cash currency and digital wallets that hold cryptocurrency like Bitcoins. Cryptocurrency has been around for quite some time now, and who knows what the future holds for cryptocurrency. Currently the adoption and usage of cryptocurrency is low, however with the society moving towards a cashless economy, you never know, maybe cryptocurrency could take off in a big way. Square could also start with remittance wallets. Since US has a large number of immigrant population who are always on the lookout for good exchange rates for sending money back to their home countries, if Square is able to provide competitive exchanges rates for majority of the currencies, this could turn out to be a very lucrative business and revenue stream for Square. Since it has established itself as a reliable brand in the payments processing business, they do not have to worry about winning over people's trust like any other new entrant in this segment.

Square has always believed in innovation and this is reflected in their hardware and software. They could take this a step further by integrating voice based commands in their app. They could also collaborate with other third party apps to provide additional services. For example, they could tie up with Uber or Lyft to offer free home drops if a customer's bill went above a specified limit. This added incentive could make customers return to the same merchant and also recommend other customers in the future, thereby increasing the merchant's business.

Since Square has access to humongous amounts of data (everyday transactions), thanks to its large customer base, they can use this in the future for predictive analytics. An example of this could be predicting the store's sale in a particular month or season.

Despite all the glowing reviews and a considerable market share, Square cannot afford to get complacent. Its objective in the near future should be to become profitable. If Square is going to continue growing, it's going to have to develop a portfolio of products beyond its point-of-sale business, and that includes Square Capital. It also has other products like Square Cash and its food delivery service Caviar which it needs to focus on. Square isn't just beholden to private investors any more, but it has to match up to the expectations of the public as well. If Square is to keep growing revenue at double-digit rates and ultimately turn a profit in its low margin, competitive industry, it must continue this culture of innovation.

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