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Buy now, pay later

Evan Lorenz writes:

It's not every president whose exit upstages his successor's inauguration. Rarer still is the commander-in-chief who, after leaving office, returns to public life via the speculative asset class du jour. Donald Trump is that former POTUS as well as the namesake of Trump Media & Technology Group, which two Wednesdays ago announced a merger with Digital World Acquisition Corp., a blank-check company, sending shares up 493%.

The bull market in everything is giving everyone second chances. Except for a SoftBank Group Corp. bailout two years ago, WeWork would have come a cropper. Yet, on Oct. 21, the office-sharing avatar went public through a merger with BowX Acquisition Corp. The still unprofitable WeWork now commands a $9.8 billion market cap versus $2.7 billion in trailing sales.

All this recalls the software-like multiples that the besotted Mr. Market has chosen to hang on businesses that lack software-like margins. The Aug. 6 issue of *Grant's* examined three such overvalued specimens. New-age insurer Lemonade, Inc. has subsequently declined by 22.6% and Mister Car Wash, Inc. by 10.3%, while Affirm Holdings, Inc. (AFRM on the Nasdaq) has disobligingly shot to the moon, rallying by 126.1%.

Following is a review of our losing pick-not-to-click, as well as an examination of a pair of new IPOs, Warby Parker, Inc. (WRBY on the New York Stock Exchange) and European Wax Center, Inc. (EWCZ on the Nasdaq). In preview, we're bearish on the lot.

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Affirm is a giant in the buy-now-pay-later lending field, the millennial-approved alternative to credit cards. Think of BNPL as a form of reverse layaway: Rather than paying now and consuming later, customers consume now and pay later. Unlike layaway credit, BNPL loans charge interest (the cost of which the merchant may choose to defray). However, Affirm assesses no late fees, nor does it charge for missed payments ("we never profit from consumers' mistakes," the 10-K report would like you to know).

BNPL appeals to younger consumers who lack strong credit profiles and may give traditional credit cards the side eye. Looking at Affirm's past securitizations, it appears that its borrowers' FICO scores hover between subprime and the bottom end of prime (*Grant's*, Aug. 6).

Branching out from its core business, Affirm is adding a feature to allow the purchase and sale of cryptocurrencies; a program to fund the working capital of merchants who accept Affirm's BNPL payments; and a new Debit+ card, which will link to a customer's checking account and provide the option to toggle payments between checking and BNPL.

But none of these forays explains why the stock has more than doubled in the past two months. A more likely source of propulsion was Affirm's Aug. 27 announcement that Amazon.com, Inc. would feature the BNPL lender as a payment option.

Consider, first, however, what the Everything Store transaction is not. It's not the Bezos brainchild's first BNPL partnership—that was with Zip Co. Ltd. in Australia in 2019. Nor is it Amazon's first American BNPL experiment—the e-tailer already offers installment payment plans. Neither does the deal confer exclusivity, something that Affirm disclosed three days later, in an 8-K report.

What the Amazon deal does represent is top-line growth, much like the exclusive agreement that Affirm struck with Shopify, Inc. earlier this year. In consequence, the Street estimates a 40% bump in revenue to $1.2 billion in the fiscal year ending June 30, 2022 (and to $2.3 billion by June 30, 2024), from $870.5 million in fiscal 2021. But it is profitless growth, as analysts project red ink throughout the period.

This is a problem for a stock valued at 48.9 times enterprise value to sales, and Affirm acknowledged as much during its Sept. 28 investor day. When revenue growth slows to between 20% and 30% over an unspecified number of years, said the front office, adjusted operating margins will rise to between zero percent and 10% of sales, from an anticipated negative 11%–13% in fiscal 2022. Longer-term, management projected a margin surge to between 20% and 30% of sales due to a "slower rate of investment," as CFO Michael Lindford put it. (There is an asterisk here, however, as Affirm defines adjusted operating income as Ebitda plus stock compensation and other costs.)

In fact, none of the big, pure-play BNPL lenders like Klarna or Afterpay Ltd. is profitable. In a report last month, Fahed Kunwar, a partner at U.K. broker Redburn, aggregated the figures from

Don't buy now

source: The Bloomberg

the three largest BNPL lenders and found that, on average, the trio earns 4% of a loan's value in interest while paying 3.7% in interchange and network fees, card-processor costs, reserves for credit losses and borrowing expenses. It leaves a paltry 0.3% in gross profit. Those 30 basis points are all that remain to pay the advertising costs to attract new borrowers and to cover the general and administrative expenses in one of the most forgiving credit environments ever.

"[T]he banks analyst in me cannot help but note the pricing structure barely works even when assuming all-time low credit losses," Fahed added. "If these were raised to a through-cycle level, the economics of BNPL collapses." According to data from the Federal Deposit Insurance Corp., U.S. bank net charge-offs are the lowest as a percentage of loans outstanding since at least 1984 (*Grant's*, Oct. 15).

Bulls on Affirm look to markets like Sweden and Australia, where BNPL accounted for 25% and 14%, respectively, of online retail sales. However, Lisa Ellis, a partner at MoffettNathanson, LLC, cautions that there are specific reasons why BNPL has succeeded in those countries. For one, each has an outsize cohort of young consumers. For another, those consumers are much deeper in hock than their American counterparts are: U.S. household debt sums to 96% of income versus 200% in Sweden and 210% in Australia.

Nor are credit cards such a compelling consumer option in Sweden and Australia. In Sweden, regulators have thrown up barriers to revolving credit. In Australia, the government has ratcheted down credit-card interchange fees over the past two decades and shifted the cost of cards to consumers from merchants. Thus, the Australian consumer is looking at high costs and meager loyalty points.

One may conjecture that, as Affirm's American customers get older and build their credit scores, they may pick up the credit-card habit. "From a consumer share-of-wallet perspective," Ellis tells me, "my view is that BNPL will likely remain a fairly specialized model. In the United States, consumers have very broad and sophisticated access to credit, and they love it. Most people love their credit card rewards and all of the programs around them."

And this is before the competition stiffens. On Sept. 28, Mastercard, Inc. rolled out a BNPL offering that allows any card issuer in its network to offer the buy-now-pay-later option. Visa, Inc. is testing a pilot BNPL program with select lenders now and plans to welcome all issuers to its network later. PayPal Holdings, Inc., which had 403 million customers as of June 30, is also ramping up its installment-payment options; management says it funded $1.5 billion's worth of BNPL loans in the second quarter, up from $1 billion in the first. For comparison, Affirm, which counts 7.1 million customers, processed $2.5 billion in the June quarter.

Of the 13 analysts who cover the stock, 8 say buy and only one says sell. Insiders have neither bought nor sold shares since we went to press in August.

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Read enough prospectuses, and you learn something—for instance, that most aspiring investor-owned corporations show less than $1.07 billion in trailing revenues, the threshold to qualify as an "emerging growth company." So designated, a fledgling public company need provide only two years of audited financial statements, rather than three. It is likewise absolved (for a period of up to five years) from the usual obligation of attesting to the rigor of its internal financial controls. Multiple share classes with disparate voting rights, through which insiders keep managerial control, are another common feature of the new IPO breed.

A case in point is spectacles vendor Warby Parker, which on Sept. 29 completed a direct listing for its class-A stock (which confers one vote per share) while insiders retain class-B shares (10 votes). In the risk-factors segment of its S-1 report, Warby admits to material weaknesses in internal controls for, among other items, "processes to enforce segregation of duties, prevent and detect errors, support timely reconciliation of certain key accounts, and enable review of manual journal entries."

Inspiration struck Warby co-founder Dave Gilboa in 2008, when he lost his phone and eyeglasses on a backpacking trip through Southeast Asia. He couldn't fathom why the replacement specs, derived from a "technology that has been around for 800 years," as he's said on many occasions, cost as much as a replacement phone.

In 2010, Gilboa, along with fellow Wharton School classmates Neil Blumenthal, Andrew Hunt and Jeffrey Raider, founded Warby Parker, which offers prescription glasses (frames plus lenses) starting at $95 on its website and in its 145 physical stores. Organized as a public benefit corporation, WRBY donates a pair of glasses for each pair it sells.

Covid-19 was a boon to the online-focused retailer. Sales grew by 6.3% in the plague year, and revenue growth accelerated to 53% in the first half of 2021. Warby Parker ships up to five frames for free so that online shoppers can see how they look in different styles before they buy. This makes online sales costlier than those in actual stores. As the pandemic boosted the proportion of online business, operating losses bulged to $55.6 million in 2020 from $1.7 million in 2019.

Now the company is focused on expanding its store base, with a goal of opening 30 to 35 new shops in 2021. "If we look at most of our large competitors, they have thousands of retail stores across the U.S.," Gilboa told investors on Sept. 13. "So that just underscores the massive opportunity we have."

In other words, Warby Parker hopes to become a moderately profitable physical retailer from a currently unprofitable online merchant. *Grant's* has nothing against the strategy, but we do question WRBY's price tag of 12.6 times enterprise value to sales. Walmart, Inc., a famously profitable brick-and-mortar retailer, trades at 0.8 times EV to sales. Four of the seven analysts who cover the stock say buy, and none says sell.

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European Wax Center is another characteristic new arrival. Here there are two share classes, A and B, each with identical voting rights, but rather than cementing the founders' control the point of the dual classes appears to be to limit the tax liabilities of management and private equity sponsor General Atlantic, L.P. Another emerging growth company, EWCZ has not even tested its internal controls.

Brothers Joshua and David Coba founded the company in 2004 with a single location in Aventura, Fla. As the name implies, EWCZ is in the hair-removal line. Over the past 17 years, it has established 815 locations, of which franchisees operated all but five, and it's these franchisees who furnish the bulk of the corporate revenue. Product sales generated 55% of second-quarter sales, royalty and marketing fees, another 39%; company-operated stores chipped in the balance.

Franchisors enjoy high multiples because royalty streams hold up across the economic cycle—after all, bulls observe, it's the franchisees who bear the operating risks. But pandemics are another matter. Covid-19 hit in-store waxing hard, shrinking same-store sales across European Wax clinics by 36% and reducing Ebitda to $20 million from $34 million. Nevertheless, the Street likes the fact that "Wax Pass" loyalty memberships generate three-fifths of system-wide sales and has labeled the stock a "services-as-a-service" company, a play on the highly valued "software-as-a-service" sector.

EWCZ sizes the U.S. waxing market at $18 billion, but Jefferies, LLC estimates the in-home component of that market at fully $12 billion. In the first half of 2021, system-wide sales at European Wax annualized to $751 million, or 12.5% of the out-of-home market. Management says it can expand the store count to 3,000 units, but as mature stores generate $1 million in sales, that implies $3 billion in overall sales, or one-half of the current addressable market.

Nor is waxing a buzzy new product category. According to EWCZ, there are 10,000 independent waxing boutiques in the United States and another 100,000 wax-equipped salons. To hit its targeted 3,000 stores, the out-of-home waxing market would have to grow by 50% or more, or European Wax would have to take substantial market share from existing competitors, or some combination thereof. As to expanding the overall market, CEO David Berg notes that 95% of clients are women, so convincing men to wax is an untapped market. Who's first, fellas?

EWCZ isn't the only depilatory specialist tapping the capital markets. On Oct. 15, Milan Laser, Inc., which manages 132 clinics, filed a registration statement with the Securities and Exchange Commission to go public. While laser hair removal is more expensive than waxing, it is also permanent. Thus, to the extent Milan is successful, it will shrink the available market for European Wax. Milan's S-1 statement anticipates the building of 1,000 laser clinics over the next 15 years.

Nevertheless, European Wax trades at 12.8 times enterprise value to sales and 33.5 times Ebitda. (Because of the Covid-19 impact last year, our figures annualize first-half figures.) Of the nine analysts who cover the stock, seven say buy. There's not a seller in the lot.

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