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## Don't look down

To this day, Jack Dorsey's mobile-payments company, Square, Inc. (SQ on the Big Board), founded in 2009, stands as one of the great success stories of the fragmented fintech industry. Its share price has vaulted to $76 and change from $9 at the November 2015 IPO. People love it—even the bears call it a marvel. We agree. It's marvelous, and we're bearish.

It's a tailor-made story for the readers of *Grant's*, too. You may rather lose a limb than sell short a stock, but you will certainly be a better-informed citizen of the financial world for knowing something about a business that's strategically situated at the four-way intersection of ingenuity, credit, price control and bull-market psychology. And if there were a fifth corner, it would be M&A.

Here is a measure of psychology: Square's $32 billion stock-market capitalization is $8 billion higher than that of Twitter, Inc., Dorsey's antecedent creation, though Twitter generates nearly four times as much free cash flow as Square does and shows a GAAP profit to boot. In its decade of flourishing, Square has earned no profit. Twitter was a new, new thing in the world. Square was (and largely remains) a facilitator of technologies previously established.

Square wouldn't have achieved its success unless it had filled a need. Perhaps the principal need was simplicity. The now-famous Square dongle—just plug it into a cellphone and connect yourself to Visa or MasterCard networks—has empowered merchants large and small to join the plastic-payments portal.

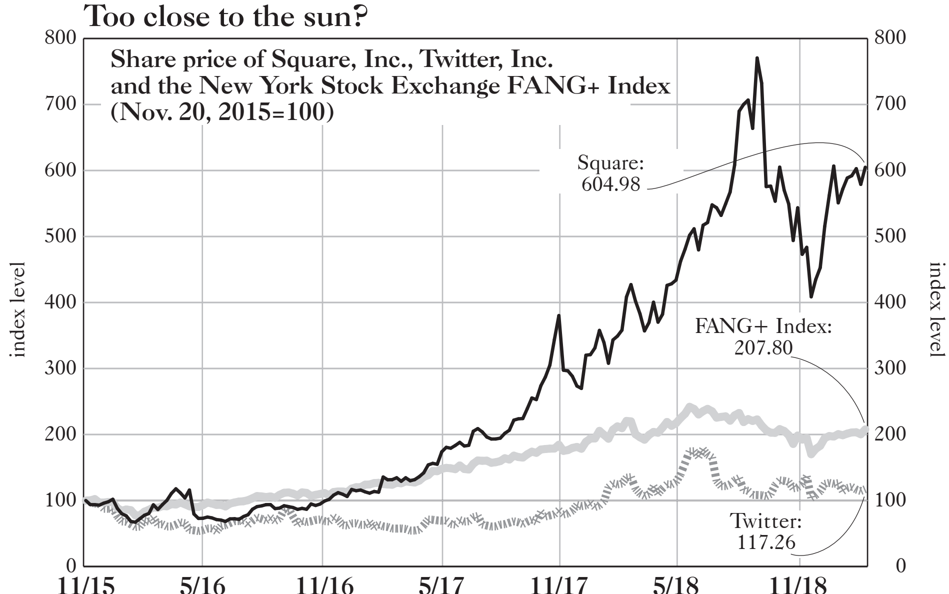
Before Dorsey had his bright idea (though it was not his alone), a merchant had to apply for membership with a so-called acquiring bank through an independent sales organization. Square, PayPal and others made the process faster and easier. Small, low-volume merchants are the particular beneficiaries because the facilitators charge flat prices. Medium and large businesses can negotiate better terms without the middle man.

In a typical transaction, Square charges 2.75% for the swipe of a card or 2.9% plus 30 cents for an online sale. Last year, this worked out to 2.92% for each dollar processed. There are costs, of course: commissions to Visa (or whatever the relevant network may be), to the third-party processor, to the acquiring bank (which moves money on Square's behalf) and to the bank that issued the card. The grand total of such fees and commissions amounted to 1.84% in 2018. Subtracted from 2.92%, they left a net transaction spread of 1.08%.

No mere card processor, Square has developed software for merchants to manage payroll, appointments and inventory. Square Capital originates short-term loans through a partnership with a Utah-chartered industrial bank. Instant Deposit provides merchants with the means to receive funds on the day they are remitted rather having to wait the customary 24 to 48 hours. Debuting late last year was Square Installments, through which merchants can offer to finance a customer purchase of between $250 and $10,000 with up to 12 fixed monthly payments.

Nor has Dorsey ignored bitcoin. Cash App allows merchants and individuals to speculate in cryptocurrencies and to

**Too close to the sun?**




source: The Bloomberg

store and send money electronically. Caviar, the Square food-delivery subsidiary, competes with Uber Eats and Grubhub. The grand design is to create a commercial ecosystem that many will want to join and few will choose to leave.

Revenues leapt to $3.3 billion in 2018, up 49% from $2.2 billion in 2017. Adjusted earnings before interest, taxes, depreciation and amortization climbed to $256.5 million, up from $139 million in 2017. The core payments-processing business generated 75% of that 2018 top line; subscription and services, bitcoin and hardware, in that order of importance, chipped in the rest. On Dec. 31, the balance sheet showed $200 million of net cash.

Gross payments volume, or GPV (Square's main performance metric), weighed in at $84.6 billion last year. Bulls envision a path to $3 trillion. They point to the existence of 21 million small and medium-size American businesses and to the demonstrated popularity (as registered in rankings at Apple's iOS app store) of Square's many apps.

"They have done a great job of understanding their business, understanding that the business was going to be cloud-based and everyone else was just a little bit behind, and that was a big thing for them," David Robertson, publisher of *The Nilson Report*, tells colleague Fabiano Santin. To which an anonymous admirer adds, "great design. Everywhere, everywhere they touch, either the audience or the market, they do it in a different way, and so they differentiate themselves from the incumbents."

Mr. Market is the uber-fan. Square changes hands at 69 times estimated 2020 "adjusted" earnings and 49 times estimated 2020 enterprise value to "adjusted" EBITDA. Then, again, free cash flow jumped to $233.9 million in 2018, up from $101.6 million in 2017.

With SoftBank Group Corp. and other tech-besotted investors scouring the earth for acquisitions, who's to say what's overvalued? Square, as noted, commands a $32 billion enterprise value. Industry leader Worldpay, Inc., which boasts $1.1 trillion in 2017 processed volume (13 times Square's volume last year), commands a $38.8 billion enterprise value (16 times 2020 adjusted EBITDA). Or it did before Monday, when Fidelity National Information Services, Inc. (FIS), shocked the world by offering to pay $43 billion for every last Worldpay share.

"My personal view," says John Davis, Jr., senior vice president and equity research analyst of the sell-side firm Raymond James, referring to Square's valuation, "is that investors are literally just baking in 10 years of unimpeded growth, and I'm not so sure that you won't see some sort of economic slowdown within the next 10 years."

Square, with its heavy exposure to pint-size brick-and-mortar retailers, is more than usually vulnerable to the business cycle. Established payment-processing companies have recurring cash flows because of the stickiness of larger merchants. There's no such stickum in the micro-merchant world, the one in which Square excelled.

Square's pricing structure is simple and its fees flat, but that doesn't mean that its fees are low. For this happy circumstance, the stockholders should not forget to thank the U.S. government.

An amendment by Sen. Richard Durbin (D., Ill.) to the 2010 Dodd–Frank Act directed the Federal Reserve to cap debit-card charges by banks with more than $10 billion in assets. In 2011, the Fed decided on a ceiling of 21 cents, plus up to 6 basis points per transaction, roughly half of the pre-regulation cost. Consumers would ostensibly reap the benefits, the Illinois statesman promised. He should have said that Square would.

Bear in mind that, because facilitators like Square are the ones that pay these fees, the new rule redounds to their benefit. "To convey a sense of the Durbin dividend," Santin relates, "assume that 20% of Square's 2018 processed volume came from debit cards subject to the ceiling. Assume, further, an average debit-card transaction of $40 for a total of 423 million transactions ($84.654 billion times 20% divided by $40). Applying the aforementioned 21 cents plus 6 basis points per transaction, debit-card charges cost Square $99 million last year. And if, indeed, as a Federal Reserve Bank of Richmond study finds, this cost is half of that which prevailed pre-Durbin, Square is saving exactly $99 million, or nearly 40% of its 2018 adjusted EBITDA."

It wasn't lost on Visa, which, in 2011 made a symbolic investment in Square's non-public share tranche. "Small merchants are willing to pay to electronify their world because they know how difficult and how expensive cash is," Visa's former CEO Charles Scharf said on a 2013 earnings call, referring to technology like Square's. Starbucks invested $25 million in Square in 2012, but thought better of it in 2017, selling the position.

The Durbin advantage may or may not prove a nonreturnable gift. Perhaps some enterprising politician will succeed in repealing it, or the Fed, sympathetic to banks chafing under Durbin's handiwork and bled by the flat yield curve, will squeeze Square by hiking the ceiling.

Nothing calls attention to itself like a sky-high valuation, and competitors are jostling to beat Dorsey at his own game. Large processing companies are partnering with point-of-sale hardware providers and software companies to undercut Square's flat rate. The world has changed since early-mover Square had the clear edge in technology and service, Robertson says: "The competitors are less likely to lose merchants to Square, which means Square is going to have to work harder to grow."

First Data Corp.'s Clover platform, which offers tablet point-of-sale systems similar to Square's, is one such interloper. From $20 billion in annualized gross payment volume in early 2016, Clover last year was registering about $70 billion's worth, a growth rate faster than Square's. Newcomers backed by venture capital and large processing companies offer hip tablet point-of-sale systems.

"GPV, as noted, is the best indicator of Square's ability to grow," Santin relates. "It's the money metric, the one on which Square earns fees. In the fourth quarter, Square's GPV grew 28% year-over-year, down from 32% in 2017, 39% in 2016 and 50% in 2015. Much of the recent growth has come from larger merchants, ones with annualized GPV of over $150,000. Their share grew to 51% of Square's volume in the quarter ended Dec. 31, 2018, up from 33% in 2014."

Square's value proposition features bundled software with simplified onboarding. As a class, small businesses raise few objections to the relatively high cost of these services—they are not so watchful over basis points of expense as the large and established ones are. "We believe Square's increasing dependence on larger sellers as a driver of its growth is an underappreciated risk factor for the company," writes Mark Palmer, managing director and financials analyst at sell-side firm BTIG.

Square thrived in a fragmented market, but consolidation is afoot—Monday's FIS-Worldpay bombshell is the latest proof. Fiserv, Inc.'s Jan. 16 bid for First Data, if consummated, would form one of the world's largest payment-processing companies. If all goes according to plan, Clover will soon face the market behind a large and experienced sales force eager to win over the kind of established, middle- and larger-sized merchants that Square is also cultivating. FIS-Worldpay would make another formidable competitor.

In technology, especially, youth will be served, and at the ripe old age of 10, Square may have lost a step in the fast-growing business of electronic commerce. Based on a review of more than 50 merchants featured in past Square quarterly shareholder letters, Lisa Ellis of MoffettNathanson Research concludes that just 30% of Square customers have become users of the Square online payment service. Stripe, Inc., which entered the market 7½ years ago and calls itself "the best software platform for running an internet business," boasts a client list including Amazon.com, Inc., Alphabet, Inc.'s Google and Microsoft Corp.

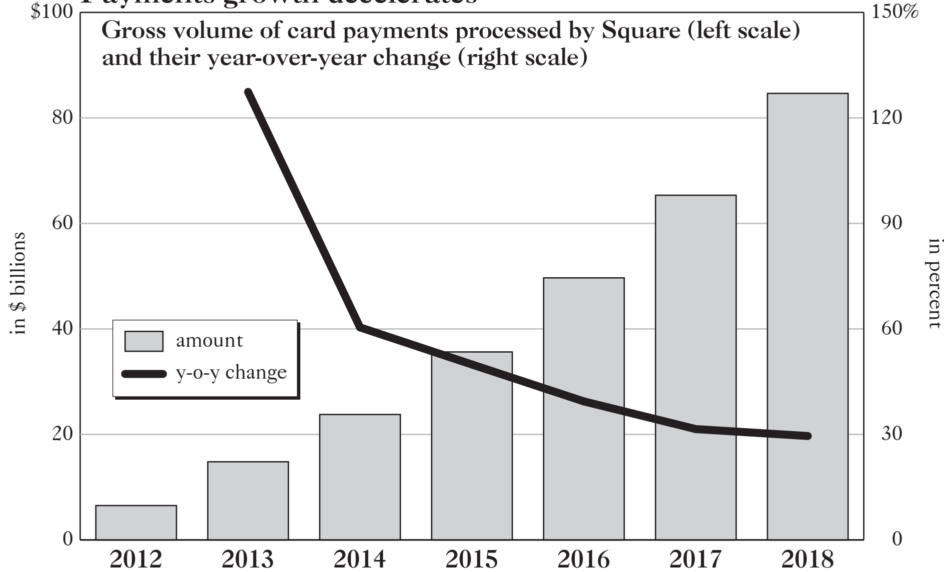
Square's money-lending ventures present another set of risks. Banking can be a good business, but it rarely commands a 69-times "adjusted" earnings multiple, even when (as in this case) the lender has access to the borrower's credit- and debit-card records.

Since its May 2014 inception, Square Capital has extended more than 650,000 loans amounting to $4 billion. Volumes are on the upswing—last year logged 250,000 loans totaling $1.6 billion—though what, if anything, they contribute to the bottom line is for management alone to know.

"There's a reason why PayPal sold its consumer credit portfolio to Synchrony," says Palmer, who has a "sell" rating on Square with a $30 target price, down 61% from the current quote. "When it did so, management said they anticipated that taking credit out of the PayPal story would lead to expanded margins. The converse of that is if you become increasingly dependent on the Square [Capital] story, then it would make sense that you would see contracting margins."

It would take a credit Puritan even purer than we to fault Square for the $13.2 million in 2018 loan losses or the $90 million in credits it classified as held for sale on Dec. 31 (though the losses seem relatively high at 14.6% of its year-end balance). The risks are prospective. The first is what awaits Square at the bottom of the next recession—it has yet to navigate its first. The second is how the market will interpret management's clear ambition to go further into the inherently fragile business of lending and borrowing.

**Payments growth decelerates**




source: company reports

As mentioned, Square Capital originates loans with a Utah-chartered, FDIC industrial bank partner and sells what it can to third-party investors. Balance-sheet risk would seem to be de minimis, though that's also what certain mortgage-backed-securities originators thought before they discovered their obligation to repurchase paper they thought they had washed their hands of in 2006 or 2007.

Then, too, Square keeps scratching at the door of the Utah banking authorities to procure its own charter to originate its own loans as a so-called industrial bank. It submitted an application in 2017–18, only to withdraw it before the authorities could pass judgment. It reapplied in December. Industrial banks take FDIC-insured deposits (though, above a certain size, not demand deposits) and extend loans under state charters, most commonly Utah's. Square says it intends to spend $56 million to capitalize its new venture. It will need better luck than Walmart, Inc., which fought a losing 20-year battle to open a bank of its own, its opponents decrying the retail company's supposed intent to execute an end-run around the federally insured and regulated banking system.

On Oct. 10, Square's long-time CFO Sarah Friar announced her departure to become CEO of closely held Nextdoor.com, Inc., a nine-year-old social network that has so far raised just $285 million. "I think there's still an open question about leadership at Square after Friar's departure," Palmer tells Santin. "[She] was much more than your typical chief financial officer for Square, provided leadership direction and to a large extent was the face of the firm before investors." In January, Mary Kay Bowman, Square's then head of payments, announced that she was leaving to join Visa.

Except for one instance four years ago, no insider has ever bought a single share of Square, even as management has expensed a cumulative $936 million in stock-based compensation. In the past 12 months insiders sold $521 million, led by $259 million from co-founder Jim McKelvey, who has since become an independent director of the Federal Reserve Bank of St. Louis. Not far behind McKelvey was Dorsey himself, who dumped $228 million's worth. Sell-side analysts are not so unanimously bullish as you might suspect: There are 17 buys, 15 holds and—lo and behold—4 sells.

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