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High-tech dress-up

Evan Lorenz writes:

Credit Suisse Group A.G.'s frank admission concerning its notorious troubles with client Archegos Capital Management—"a lackadaisical attitude towards risk and risk discipline"—has broad application in today's everything bubble. Lackadaisical towards risk, Mr. Market is none too focused on business models, either.

Old wine in new bottles is the subject at hand, in particular the bottles labeled "tech" that promotional vintners fill with the plonk of everyday businesses. In preview, we are bearish on Lemonade, Inc. (LMND on the New York Stock Exchange), Affirm Holdings, Inc. (AFRM on the Nasdaq) and Mister Car Wash, Inc. (MCW on the NYSE).

You can't blame old-economy promoters for wishing that they, too, hailed from Silicon Valley. In the first six months of the year, 73 tech companies completed initial public offerings, up from 16 in the same period of Covid-addled 2020 and 27 in the opening half of 2019.

Or consider that, according to Bloomberg, 818 companies trade at ratios of enterprise value to sales in excess of 20 times compared with just 338 companies so valued at the March 2000 Nasdaq 100 peak.

Now as then, scalable technology business models are in the eye of the beholder. It was the digital glitter so liberally applied by venture-capital stalwarts like Benchmark and by v.c. johnny-come-latelies like SoftBank Group Corp. that earned the shared-office provider WeWork its $47 billion valuation in 2019.

But, of course, WeWork was and remains a real estate company. How this obvious truth eluded seasoned deal makers is a recurring theme of *The Cult of We: WeWork, Adam Neumann, and the Great Startup Delusion* by Eliot Brown and Maureen Farrell.

"Typically, venture capitalists don't invest in real estate, because it can't scale like a software company," the authors write. "The whole allure of software companies is that once they spend money to build their products, they can sell more and more software to new users at very low costs—sometimes just the price of sending a file. Profits grow exponentially."

Real estate, in contrast, is capital-intensive and low-margin under the best of managements. It took the August 2019 filing of WeWork's S-1 registration statement to remind the market of that fact. Prospective investors balked at the $904.7 million of losses rolled up in the first half of 2019 and at the way co-founder Adam Neumann siphoned off value for himself (he even dunned his own company for the use of the word "we," which, somehow, Neumann had trademarked).

In the wake of the IPO that never was, chastened venture capitalists paused to reflect. Eniac Ventures went so far as to calculate the gross margins of its portfolio companies, *The New York Times* cited Nihal Mehta, the firm's general partner, as saying. According to the *Times*, paraphrasing Mehta, "This was not something the firm regularly looked at."

The introspective moment came and went. WeWork, which posted negative $424 million in Ebitda in the first quarter, excluding its money-losing China operations, is merging with BowX Acquisition Corp., a blank-check company, at a $9 billion valuation. And Masa Son is once again crowning tech champions. On July 15, SoftBank invested in Revolut Ltd., a fintech entry, at a $33 billion valuation, up sixfold from the prior funding round in 2020.

Last week, the CFA Institute announced a 25% pass rate for takers of the Level I exam in June, lowest since the test was first administered in 1963 and a shocking departure from the 10-year average pass rate of 42%. Then again, perhaps, not so shocking when you reflect on how little analysis avails you when everything that isn't nailed down goes up.

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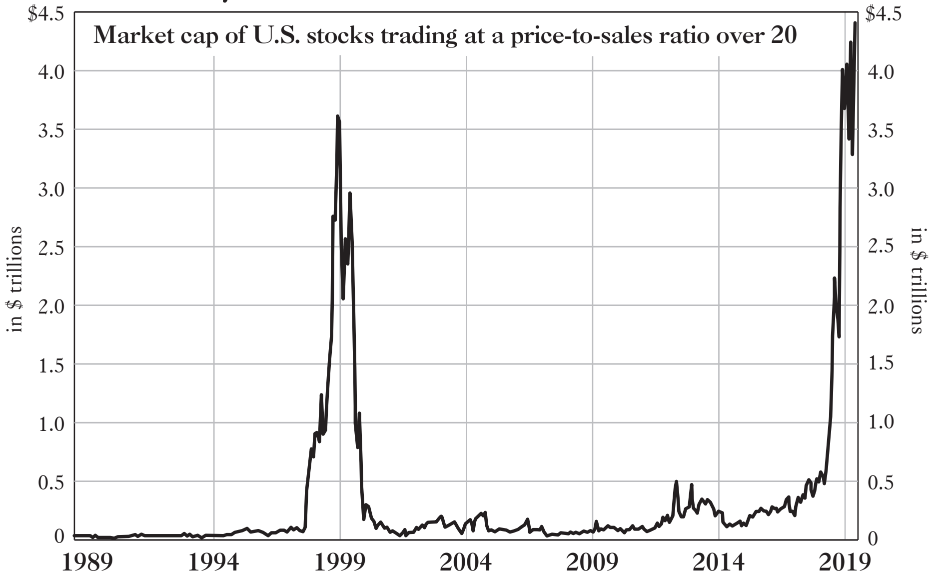
Lemonade is an insurance company that was founded in 2015 to shake up a supposedly analogue industry. No forms, no agents, a bare minimum of human contact, is the pitch. You can sign up for renters', homeowners', pet or life insurance following a two-minute chat with an automated Lemonade bot named AI Maya. To file a claim, talk to AI Jim, which can facilitate payments in a matter of seconds.

Lemonade ("When life gives you lemons…"), which underwrites its own renters', homeowners' and pet policies, says it plans to add auto insurance. The capital-intensive life business is another matter, and here Lemonade—with owners' equity of just $1.1 billion as of March 31—serves as an agent for other carriers.

Inflation by another name



source: Kailash Capital, LLC

To economize on capital, the company cedes 75% of premiums and risk to reinsurers. At the end of the first quarter, in-force premiums before reinsurance totaled $252 million, an 89% year-over-year increase.

While Lemonade uses big data to underwrite policies and create a slick user interface, it's stingy with that information. Thus, its filings to the Securities and Exchange Commission are silent on the number of policies it writes and the proportion of premium by product line. On the May 12 earnings call, management indicated that renters' insurance accounted for approximately half of premiums and around 90% of policies written.

Wowed by the fancy Lemonade app and direct-to-consumer focus, the market values LMND like a software company rather than the (unprofitable) insurance business it inescapably is. The shares trade at 34.8 times enterprise value to estimated 2021 sales and 9.1 times book value. Progressive Corp., the star pupil of the personal-insurance industry, trades at 1.3 times 2021 sales and 3 times book value.

"Insurtech," it may say on the Lemonade bottle, but the company's thin margins blare the prosaic truth. In 2020, the upstart paid out $0.71 of every dollar in premiums it received in claims. That left $0.29 to cover overhead and advertising to attract new customers and to enlarge the capital base for writing new policies. (The loss ratio spiked to 121% in the first quarter, owing to damages from Winter Storm Uri in Texas.)

The high cost of online customer acquisition and the fact that those customers tend to be flighty is a problem for the Lemonade business model. According to a June 10 report by Ryan Tunis, who rates the shares a sell for Autonomous Research, the cost of the adword "renters insurance" on Google rose to $18.74 in the June quarter, from $15.43 in the identical period of 2020. Lemonade says its average renters' policy costs $60 per year. After ceding 75% of the revenue to reinsurers and paying out 71% of the premium in losses, that leaves $4.35 in gross profit, implying that it would take 4.3 years to cover the ad outlay before attending to corporate overhead. Given a 75% customer retention rate after year one, the current customer base may never become profitable.

All of which may explain why Lemonade is trying to crack the extra-hard nut of auto insurance. Given the time required to gather data and adjust underwriting parameters, three or four years of losses is the standard price of admission to any new insurance market. Management hopes that customers who sign up for more than one product will stick around, thereby hastening the day of positive net income.

Lemonade's direct-to-consumer focus won't make that job any easier, since three-fourths of homeowners' and auto policies are sold bundled. "If you have a renters' policy with Lemonade and you go buy house," Tunis tells me, "you don't tell the loan officer, 'Can you wait two days while I get my Lemonade policy? I really like my carrier.' That's not how it works. The loan officer tells you to use this independent agent, and they will get it done fast. The biggest reason a mortgage application falls apart is issues with insurance. Upselling sounds like it could be good intuitively, but there is no loyalty to your insurance carrier when you are making the biggest purchase of your lifetime."

Interestingly, two of the three insurance analysts who rate Lemonade call the shares a sell, while three out of five tech-stock analysts who follow the company call them a buy. Short interest stands at a towering 22% of the float, and management seems to agree with the bears. Over the past 12 months, insiders have sold 3 million shares for proceeds of $352.3 million.

"At the end of the day, it's just an insurance company," Steve Virgili, a portfolio manager at Highland Park, Ill.–based New Vernon Wealth Management, LLC, a fund that focuses on the insurance sector, tells me. "They write insurance, they sell insurance, they bring in premium and they have to pay out claims. Period. End of story."

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Affirm is a so-called fintech with a specialty in the area of buy-now-pay-later (BNPL). Founded in 2012 and public since Jan. 12, the company facilitates consumer purchases on the installment plan.

The corporate M.O., broadly drawn from the Bible, reads in part: "Our company is predicated on the principles of simplicity, transparency, and putting people first. This distinctive culture sets us apart, as our principles are not just words on a wall, but how we—Affirmers—run our business and design our products. Since our founding in 2012, we have charged $0 in late fees for missed payments, we never profit from consumers' mistakes, and we are transparent in our product offerings."

To generate revenue, the BNPL lender partners with merchants to offer consumers installment loans at a rate of zero percent. In such cases, the merchant compensates the lender with a fee calculated as a percentage of the purchase price (which delivered 42.5% of Affirm's revenue in the March quarter). When merchants don't subsidize loans, consumers pay interest to Affirm (41% of such revenue). Selling loans and servicing loans sold to third parties likewise bring in revenue (7.1% and 3.5%, respectively, in the third quarter).

In the three months ended March 31, Affirm facilitated $2.3 billion's worth of gross merchandise value (GMV), an 83% year-over-year increase, which powered a 67% surge in revenues. Even so, the ink is red, and Wall Street doesn't expect Affirm to generate positive Ebitda until the fiscal year ending June 30, 2024. Peloton Interactive, Inc., Affirm's single largest partner, accounted for 18% of GMV in the quarter. Growth should get a boost from a deal signed last year with Shopify, Inc. which will make Affirm's installment loans an option for more than a thousand Shopify-affiliated merchants.

Affirm's S-1 omits any reference to a FICO credit score or the term "subprime." More informative is the July 22 DBRS Morningstar report on a recent Affirm debt deal—the Affirm Asset Securitization Trust 2021-B—in which 48.8% of the loans sold on July 27 scored a weighted average of 668 on the FICO scale (i.e., on the cusp of subprime) and bore an average interest rate of 19.1%.

Nor does Affirm have the BNPL market all to itself. In addition to established installment players like the SoftBank-backed Klarna Bank A.B. and Afterpay Ltd., PayPal Holdings, Inc. and Apple, Inc. are creating new BNPL services. Visa, Inc. is piloting a program that allows card-issuing banks on its credit-card network an entrée into BNPL, and Mastercard, Inc. is reportedly working on a version of its own. This would make almost every commercial bank a BNPL competitor.

"Visa and Mastercard like to democratize payment capabilities—they standardize services and offer them to all players," Lisa Ellis, who covers the credit-card networks for MoffettNathanson, LLC, told *Investor's Business Daily* on July 27. "So they are lowering the barriers-to-entry for BNPL—not good for PayPal, Afterpay, Affirm, and Klarna."

Competition isn't coming only from the card networks, however. On Monday, Square, Inc. made an all-stock bid for Afterpay in a deal valued at $29.3 billion, or 41.8 times estimated sales for the fiscal year ended June 30, 2021. The millions of small merchants who use Square's payment solutions as well as the 70 million consumers who use Square's Cash App will now have the choice of using Afterpay's installment-payment system, if the deal closes.

There is nothing particularly special about a loss-making subprime lender, especially in a niche that's facing a rapid increase in competition. Yet, Affirm commands a multiple of EV to estimated fiscal 2021 sales of 20.2 times. On July 2, Banco Santander S.A. made an offer to acquire the shares it does not own of Santander Consumer USA, Inc., a subprime auto lender, at a price equal to 1.5 times sales. And, unlike Affirm, Santander Consumer is profitable.

Sell-side analysts, of whom eight say buy, three say hold and only one says sell, seem to have a higher opinion of the stock than the Affirm front office does; since the January IPO, insiders have unloaded 341,025 shares for proceeds of $36.5 million. Short interest totals 8.4% of the float.

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Rounding out our overrated trio is the operator of 344 car washes in 21 states. Its subscription-centered business model is why Mister Car Wash, founded in 1996 to participate in what was already a mature retail business, can pass for a tech stock. Some three-fifths of revenues derives from monthly subscriptions, good for unlimited washes, and that's all the proof the Street requires for calling Mister a "services-as-a-service" company, a twist on "software-as-a-service."

Thus, a pair of Jefferies analysts, Randal Konik and Corey Tarlowe, recently likened Mister to Planet Fitness, Inc., which provides "consumers with a specific set of tools that are meant to become part of a larger ecosystem to help customers live a healthier lifestyle (unlimited access to 2,000+ gyms, digital content, etc.)." In Mister's case, the tools for better living consist of "a comprehensive suite of services to support particular aspects of vehicle maintenance." Cash washes, for instance.

But by no means is the car-wash subscription model unique to Mister. Brooklyn's Famous Car Wash, which operates a single location in New York City's most populous borough, sells a variety of unlimited wash packages. And before the advent of the internet, you could buy a punch card.

Nevertheless, Mister trades at a hefty 10.8 times enterprise value to estimated 2021 sales and 28.6 times EV to Ebitda. Management says it can expand its store base to 1,000 units through a combination of acquisitions and new construction and that the outlets each produce stabilized Ebitda of around $700,000 per annum before corporate overhead.

Let's see about that: Giving the company credit for the additional 656 stores and the $459.2 million in additional Ebitda (that is, 656 stores times $700,000) would value MCW at 9.9 times Ebitda. Importantly, this calculation doesn't burden Mister's enterprise value with the cost of expansion and assumes no increase in general and administrative expenses to manage the larger operations.

Walmart, Inc., a not-insignificant retailer with its own membership program ($12.95 a month gives Walmart+ members free shipping and more), trades at 12.2 times EV to 2021 estimated Ebitda. If that's a fair multiple for a mature retail business that sells by subscription, the market is already capitalizing MCW as if its planned expansion to 1,000 units were fact rather than ambition.

A public company for six weeks, MCW has garnered just eight analyst ratings (of which three are bullish) and a starter short interest of 1.8% of the float. As part of its June 24 IPO, management dumped 3 million shares for proceeds of $45.8 million.

But a new prospectus, filed on July 27, clears the way for the sale of another 5.3 million shares by insiders and of another 68.9 million shares by Mister's former private equity sponsor, Leonard Green & Partners, L.P.

"There are a lot of mundane businesses or businesses that are dressed up with a wrapper of software-as-a-service or whatever," Jim Chanos, founder and managing partner of Kynikos Associates, L.P., tells me.

"You will see Wall Street create a lot more of them. I always joke that Wall Street has a printing press just like the Fed, but that it takes longer for Wall Street to get going. I think that Wall Street's printing press is up and running, and we are going to see more and more valuations stay high."

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