

## Equity Research

November 9, 2017

### Mark Palmer

(212) 588-6582  
mpalmer@btig.com

### Giuliano Bologna

(212) 588-6583  
gbologna@btig.com

## Financials

### Square Inc.

#### Underwhelming Stock Price Reaction to Solid 3Q17 Report Shows Progress Already Baked into Valuation

Square Inc. (SQ) yesterday after the market close delivered a 3Q17 report featuring what has become its customary beat-and-raise on adjusted revenue, adjusted EBITDA and adjusted earnings per share. Management's FY17 guidance called for adjusted revenue growth to accelerate and for adjusted EBITDA margins to expand.

- ▶ Yet after SQ posted that impressive array of operating metrics, the company's shares fell during extended trading. We believe that underwhelming reaction to a strong quarterly report demonstrated that SQ's valuation already reflects much of the good news that the company has to offer at this point. It also may indicate that the stock may struggle to find its next leg up unless management can come up with additional avenues for future growth that investors are not already anticipating.
- ▶ **We are reiterating our Neutral rating for SQ.** The company's shares trade at 25.5x our FY20E adjusted EBITDA, a level at which they may have hit a valuation ceiling such that the stock could be range-bound until the company offers additional reasons for investors to be inspired by its story.
- ▶ SQ reported 3Q17 adjusted EBITDA of \$34.3mm, exceeding the consensus estimate of \$32.4 and our estimate of \$29.7mm, as its adjusted EBITDA margin of 13% was in line with management's guidance. Adjusted revenue accelerated during the quarter, growing by 45% year-over-year to \$257mm after growing by 41% during 2Q17.
- ▶ Meanwhile, SQ's gross payment volume (GPV) increased during 3Q17 by 31% year-over-year to \$17.4bn. GPV derived from midmarket sellers – those with more than \$500K in annual GPV – grew by 64% versus the prior year period, accelerating from the 61% growth produced by such sellers during 2Q17.
- ▶ **Valuation:** SQ trades at 25.5x FY20E adj. EBITDA, and we believe the stock is fully valued based on comparable multiples. Our EV/EBITDA valuation of SQ is within +/- 15% from current levels over the next 12 months. BTIG does not assign price targets to Neutral-rated stocks.

SQ

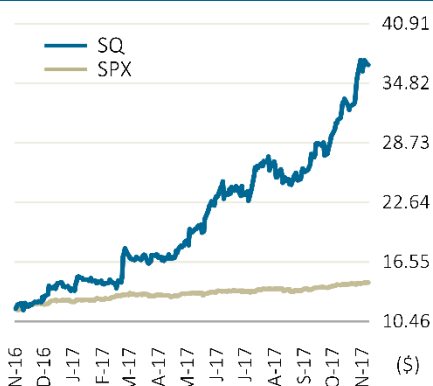
\$36.71

### NEUTRAL

52 week range \$11.65 - \$37.19

Market Cap (m) \$14,095

#### Price Performance



Source: IDC

## Estimates

	1Q16 A	2Q16 A	3Q16 A	4Q16 A	FY16 A	1Q17 A	2Q17 A	3Q17 A	4Q17 E	FY17 E	FY18 E
Sales	379	439	439	452	1,709	462	552	585	598	2,196	2,819
EBITDA (Adj.)	(8)	13	12	30	46	27	36	34	36	134	248

Source: BTIG Estimates and Company Documents (\$ in millions, except per share amount)

- ▶ Transaction-based profit as a percentage of GPV rose to 1.05% during 3Q17, up from 1.01% during the prior year period. Management attributed the increase in part to strong growth in Invoices, Virtual Terminal and E-Commerce API payments that helped to offset the impact of custom pricing offered to certain larger sellers.
- ▶ SQ's subscription and services-based revenue, a key metric inasmuch as it reflects demand for the ancillary products that represent an important source of future revenue growth and margin expansion, was up 84% year-over-year to \$65mm. However, that rate represented a slowdown from the 99% year-over-year growth the segment posted during the prior quarter.
- ▶ At the same time, Square Capital's growth rate also slowed during 3Q17 versus that achieved during the prior quarter. The unit facilitated 47,000 loans totalling \$303mm, a 45% increase versus the prior year period. Those figures were down from the 68,000 loans totalling \$318mm, representing 68% year-over-growth, the unit reported for 2Q17.
- ▶ SQ boosted its FY17 guidance in light of its strong 3Q17 results. Management lifted their adjusted revenue guidance to a range of \$963mm to \$966mm – the consensus estimate had been \$944.5mm prior to the report – from a range of \$925mm to \$935mm, with the new midpoint reflecting expected growth of 41% versus the 35% associated with the prior midpoint. They attributed their expectation of acceleration in revenue growth to outperformance across the franchise as well as increased contributions from midmarket sellers.
- ▶ Management also raised their FY17 adjusted EBITDA guidance to a range of \$132mm to \$135mm from a range of \$120mm to \$128mm. The consensus estimate prior to the 2Q17 report had been \$132.9mm. The midpoint of the new range translates into an adjusted EBITDA margin of 14%, up from the 13% midpoint of the previous range.
- ▶ SQ also raised its FY17 adjusted EPS guidance to a range of \$0.24 to \$0.25, up from the prior range of \$0.21 to \$0.23. The consensus estimate had been \$0.24 prior to the report.

## Income Statement

Square Inc. - Operating Model	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Dec-18	Dec-19	Dec-20
\$ millions	2012A	2013A	2014A	2015A	2016A	1Q17A	2Q17A	3Q17A	4Q17E	2017E	1Q18E	2Q18E	3Q18E	4Q18E	2018E	2019E	2020E
Transaction-based revenue	193.98	433.74	707.80	1,050.45	1,456.16	403.48	482.07	510.02	512.22	1,907.79	504.85	615.29	652.02	655.39	2,427.55	3,124.66	4,031.89
Starbucks transaction-based revenue	9.47	114.46	123.02	142.28	78.90	-	-	-	-	-	-	-	-	-	-	-	-
Subscription and services-based revenue	-	-	12.05	58.01	129.35	49.06	59.15	65.05	73.62	246.89	70.94	83.40	87.92	99.41	341.67	448.35	591.22
Hardware revenue	-	4.24	7.32	16.38	44.31	9.02	10.29	10.09	12.28	41.68	10.82	12.35	12.11	14.74	50.01	57.51	63.26
<b>Total net revenue</b>	<b>203.45</b>	<b>552.43</b>	<b>850.19</b>	<b>1,267.12</b>	<b>1,708.72</b>	<b>461.55</b>	<b>551.51</b>	<b>585.16</b>	<b>598.13</b>	<b>2,196.35</b>	<b>586.61</b>	<b>711.03</b>	<b>752.05</b>	<b>769.54</b>	<b>2,819.24</b>	<b>3,630.52</b>	<b>4,686.37</b>
Transaction costs	126.35	277.83	450.86	672.67	943.20	257.78	311.09	328.04	335.60	1,232.51	331.91	404.51	428.66	430.88	1,595.97	2,066.83	2,683.24
Starbucks transaction costs	12.55	139.80	150.96	165.44	69.76	-	-	-	-	-	-	-	-	-	-	-	-
Software and data products cost	-	-	2.97	22.47	43.13	15.88	17.12	18.17	23.38	74.54	21.47	25.24	26.60	30.08	103.39	128.95	164.12
Hardware cost	-	6.01	18.33	30.87	68.56	12.66	14.17	18.78	14.49	60.10	12.55	14.32	14.04	16.95	57.86	66.14	69.59
Amortization of acquired technology	-	-	1.00	5.64	8.03	1.81	1.70	1.56	1.63	6.69	1.72	1.80	1.89	1.99	7.39	8.99	10.92
<b>Total cost of revenue</b>	<b>138.90</b>	<b>423.65</b>	<b>624.12</b>	<b>897.09</b>	<b>1,132.68</b>	<b>288.12</b>	<b>344.08</b>	<b>366.54</b>	<b>375.10</b>	<b>1,373.85</b>	<b>367.64</b>	<b>445.88</b>	<b>471.20</b>	<b>479.90</b>	<b>1,764.62</b>	<b>2,270.91</b>	<b>2,927.88</b>
<b>Gross profit (loss)</b>	<b>64.55</b>	<b>128.79</b>	<b>226.07</b>	<b>370.03</b>	<b>576.04</b>	<b>173.43</b>	<b>207.43</b>	<b>218.62</b>	<b>223.03</b>	<b>822.50</b>	<b>218.97</b>	<b>265.16</b>	<b>280.84</b>	<b>289.65</b>	<b>1,054.62</b>	<b>1,359.62</b>	<b>1,758.49</b>
Product development	46.57	82.86	144.64	199.64	268.54	68.58	78.13	82.55	84.23	313.48	78.21	94.72	100.11	102.36	375.40	455.11	550.92
Sales and marketing	56.65	64.16	112.58	145.62	173.88	49.90	59.92	66.53	68.01	244.36	63.77	77.22	81.60	83.42	306.00	374.82	470.70
General and administrative	36.18	68.94	94.22	143.47	251.99	56.94	62.99	64.31	66.24	250.48	66.90	67.57	68.25	68.93	271.66	282.69	294.16
Transaction and advance losses	10.51	15.33	24.08	54.01	51.24	11.89	18.40	19.89	20.19	70.38	18.22	22.21	23.54	23.66	87.63	113.19	146.56
Amortization of acquired customer assets	-	-	1.05	1.76	0.85	0.21	0.22	0.22	-	0.65	-	-	-	-	-	-	-
Impairment of intangible assets	-	2.43	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
<b>Total operating expenses</b>	<b>149.91</b>	<b>233.73</b>	<b>376.57</b>	<b>544.49</b>	<b>746.49</b>	<b>187.51</b>	<b>219.65</b>	<b>233.51</b>	<b>238.67</b>	<b>879.34</b>	<b>227.10</b>	<b>261.73</b>	<b>273.49</b>	<b>278.37</b>	<b>1,040.69</b>	<b>1,225.80</b>	<b>1,462.34</b>
<b>Operating income (loss)</b>	<b>(85.36)</b>	<b>(104.94)</b>	<b>(150.49)</b>	<b>(174.46)</b>	<b>(170.45)</b>	<b>(14.08)</b>	<b>(12.22)</b>	<b>(14.89)</b>	<b>(15.64)</b>	<b>(56.84)</b>	<b>(8.13)</b>	<b>3.43</b>	<b>7.35</b>	<b>11.27</b>	<b>13.93</b>	<b>133.81</b>	<b>296.15</b>
<b>Adjusted EBITDA</b>	<b>(70.58)</b>	<b>(51.53)</b>	<b>(67.74)</b>	<b>(41.12)</b>	<b>45.74</b>	<b>27.03</b>	<b>36.50</b>	<b>34.30</b>	<b>35.76</b>	<b>133.58</b>	<b>40.52</b>	<b>62.41</b>	<b>69.72</b>	<b>75.10</b>	<b>247.75</b>	<b>416.77</b>	<b>637.97</b>
Interest (income) and expense	0.01	(0.01)	1.06	1.16	(0.24)	0.50	3.27	1.85	0.50	6.12	0.50	0.50	0.50	0.50	2.00	2.00	2.00
Other (income) and expense	(0.17)	(0.95)	1.10	0.45	(0.54)	-	-	-	-	-	-	-	-	-	-	-	-
<b>Income (loss) before income taxes</b>	<b>(85.20)</b>	<b>(103.98)</b>	<b>(152.65)</b>	<b>(176.07)</b>	<b>(169.67)</b>	<b>(14.58)</b>	<b>(15.49)</b>	<b>(16.74)</b>	<b>(16.14)</b>	<b>(62.96)</b>	<b>(8.63)</b>	<b>2.93</b>	<b>6.85</b>	<b>10.77</b>	<b>11.93</b>	<b>131.81</b>	<b>294.15</b>
Provision for income taxes	-	0.51	1.44	3.75	1.92	0.51	0.47	(0.65)	-	0.33	-	-	-	-	-	-	-
<b>Net income (loss)</b>	<b>(85.20)</b>	<b>(104.49)</b>	<b>(154.09)</b>	<b>(179.82)</b>	<b>(171.59)</b>	<b>(15.09)</b>	<b>(15.96)</b>	<b>(16.10)</b>	<b>(16.14)</b>	<b>(63.29)</b>	<b>(8.63)</b>	<b>2.93</b>	<b>6.85</b>	<b>10.77</b>	<b>11.93</b>	<b>131.81</b>	<b>294.15</b>
<b>Adjusted EPS - Diluted</b>				<b>(0.39)</b>	<b>0.04</b>	<b>0.05</b>	<b>0.08</b>	<b>0.08</b>	<b>0.06</b>	<b>0.28</b>	<b>0.07</b>	<b>0.12</b>	<b>0.13</b>	<b>0.14</b>	<b>0.47</b>	<b>0.80</b>	<b>1.19</b>
Shares outstanding - diluted				170.50	362.58	366.74	376.36	383.95	389.71	379.19	395.56	401.49	407.51	413.62	404.55	429.37	455.72
<b>Total net revenue</b>	<b>203.45</b>	<b>552.43</b>	<b>850.19</b>	<b>1,267.12</b>	<b>1,708.72</b>	<b>461.55</b>	<b>551.51</b>	<b>585.16</b>	<b>598.13</b>	<b>2,196.35</b>	<b>586.61</b>	<b>711.03</b>	<b>752.05</b>	<b>769.54</b>	<b>2,819.24</b>	<b>3,630.52</b>	<b>4,686.37</b>
Starbucks transaction revenue	9.47	114.46	123.02	142.28	78.90	-	-	-	-	-	-	-	-	-	-	-	-
Transaction costs	126.35	277.83	450.86	672.67	943.20	257.78	311.09	328.04	335.60	1,232.51	331.91	404.51	428.66	430.88	1,595.97	2,066.83	2,683.24
<b>Adjusted revenue</b>	<b>67.63</b>	<b>160.14</b>	<b>276.31</b>	<b>452.17</b>	<b>686.62</b>	<b>203.78</b>	<b>240.41</b>	<b>257.12</b>	<b>262.54</b>	<b>963.84</b>	<b>254.70</b>	<b>306.52</b>	<b>323.38</b>	<b>338.66</b>	<b>1,223.27</b>	<b>1,563.69</b>	<b>2,003.13</b>
<b>Net income (loss)</b>	<b>(85.20)</b>	<b>(104.49)</b>	<b>(154.09)</b>	<b>(179.82)</b>	<b>(171.59)</b>	<b>(15.09)</b>	<b>(15.96)</b>	<b>(16.10)</b>	<b>(16.14)</b>	<b>(63.29)</b>	<b>(8.63)</b>	<b>2.93</b>	<b>6.85</b>	<b>10.77</b>	<b>11.93</b>	<b>131.81</b>	<b>294.15</b>
Starbucks transaction revenue	(9.47)	(114.46)	(123.02)	(142.28)	(78.90)	-	-	-	-	-	-	-	-	-	-	-	-
Starbucks transaction costs	12.55	139.80	150.96	165.44	69.76	-	-	-	-	-	-	-	-	-	-	-	-
Share-based compensation expense	8.11	14.66	36.12	82.29	138.79	31.67	39.59	40.05	39.44	150.75	35.75	43.33	45.83	46.90	171.80	203.09	238.72
Depreciation and amortization	3.58	8.27	18.59	27.63	37.75	9.44	9.13	9.09	11.96	39.61	12.91	15.64	16.55	16.93	62.02	79.87	103.10
Interest (income) expense	0.01	(0.01)	1.06	1.16	(0.24)	0.50	3.27	1.85	0.50	6.12	0.50	0.50	0.50	0.50	2.00	2.00	2.00
Other (income) expense	(0.17)	(0.95)	1.10	0.45	48.32	-	-	-	-	-	-	-	-	-	-	-	-
Provision (benefit) for income taxes	-	0.51	1.44	3.75	1.92	0.51	0.47	(0.65)	-	0.33	-	-	-	-	-	-	-
Loss on sale of property plant and equipment	0.01	2.71	0.11	0.27	(0.05)	-	0.00	0.06	-	0.06	-	-	-	-	-	-	-
Impairment of intangible assets	-	2.43	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
<b>Adjusted EBITDA</b>	<b>(70.58)</b>	<b>(51.53)</b>	<b>(67.74)</b>	<b>(41.12)</b>	<b>45.74</b>	<b>27.03</b>	<b>36.50</b>	<b>34.30</b>	<b>35.76</b>	<b>133.58</b>	<b>40.52</b>	<b>62.41</b>	<b>69.72</b>	<b>75.10</b>	<b>247.75</b>	<b>416.77</b>	<b>637.97</b>
Tax rate	-	-0.5%	-0.9%	-2.1%	-1.1%	-3.5%	-3.0%	3.9%	0.0%	-0.5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Adjusted revenue growth	-	136.8%	72.5%	63.6%	51.9%	39.4%	40.7%	44.6%	36.8%	40.4%	25.0%	27.5%	25.8%	29.0%	26.9%	27.8%	28.1%
Transaction revenue growth	-	123.6%	63.2%	48.4%	38.6%	34.3%	32.1%	31.3%	27.3%	31.0%	25.1%	27.6%	27.8%	28.0%	27.2%	28.7%	29.0%
Software and data product growth	-	-	-	381.6%	123.0%	106.2%	99.0%	84.2%	81.7%	90.9%	44.6%	41.0%	35.2%	35.0%	38.4%	31.2%	31.9%
Hardware revenue growth	-	-	72.7%	123.6%	170.5%	-44.3%	-7.2%	23.5%	38.5%	-5.9%	20.0%	20.0%	20.0%	20.0%	20.0%	15.0%	10.0%
Adjusted EBITDA growth	-	-27.0%	31.5%	-39.3%	-211.3%	-428.5%	190.7%	195.1%	20.0%	192.0%	49.9%	71.0%	103.2%	110.0%	85.5%	68.2%	53.1%
Adjusted EBITDA margin	-104.4%	-32.2%	-24.5%	-9.1%	6.7%	13.3%	15.2%	13.3%	13.6%	13.9%	15.9%	20.4%	21.6%	22.2%	20.3%	26.7%	31.8%

Source: BTIG Estimates and Company Reports

## BTIG Covered Companies Mentioned in this Report

SQUARE INC. (SQ, Neutral, \$N/A PT; Current Price: \$36.71; Analyst: Mark.Palmer)

## Appendix: Analyst Certification and Other Important Disclosures

### Analyst Certification

I, Mark Palmer, hereby certify that the views about the companies and securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

I, Giuliano Bologna, hereby certify that the views about the companies and securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

### Regulatory Disclosures

#### Ratings Definitions

**BTIG LLC's ("BTIG") ratings, effective June 12, 2017, are defined as follows:**

**BUY** – A security which is expected to produce a positive total return of 15% or greater over the 12 months following the recommendation. The BUY rating may be maintained as long as it is deemed appropriate, notwithstanding price fluctuations that would cause the target to fall outside of the 15% return.

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**Distribution of BTIG's Research Recommendations (as of September 30, 2017):**

**BUY: 56.8%; NEUTRAL: 39.1%; SELL: 4.1%**

**Distribution of BTIG's Investment Banking Services (as of September 30, 2017):**

**BUY: 20.8%; NEUTRAL: 5.7%; SELL: 0.0%**

For purposes of FINRA ratings distribution rules, BTIG's stock ratings of Buy, Neutral and Sell fall into Buy, Hold and Sell categories, respectively.

### Company Valuation and Risk Disclosures

#### Square Inc. (SQ, Neutral)

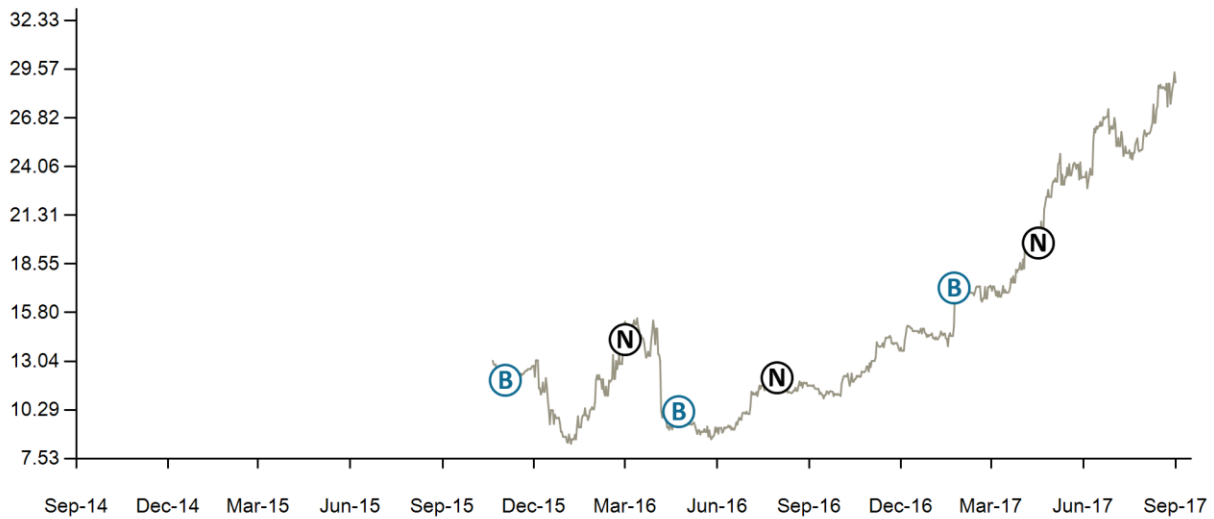
**Valuation:** SQ trades at 25.5x FY20E adj. EBITDA, and we believe the stock is fully valued based on comparable multiples. Our EV/EBITDA valuation of SQ is within +/- 15% from current levels over the next 12 months. BTIG does not assign price targets to Neutral-rated stocks.

**Risks:** The primary downside risks to our thesis include: Competition, the company's inability to meet growth targets, risk of data breaches, the risk of fraud, macroeconomic risk, risk associated with international expansion, management risk and litigation risk. Upside risks include, better than anticipated performance by the company

and an acquisition of the company.

**Square Inc. (SQ)**

(\$)



*Note: Closing Price and Target Price have been adjusted for corporate actions.*

Date	Closing Price (\$)	Target Price (\$)	Analyst	Rating
02-Dec-15	11.92	15	Mark Palmer	Buy
31-Mar-16	14.22	NA	Mark Palmer	Neutral
23-May-16	10.14	12	Mark Palmer	Buy
29-Aug-16	12.07	NA	Mark Palmer	Neutral
22-Feb-17	17.15	20	Mark Palmer	Buy
17-May-17	19.68	NA	Mark Palmer	Neutral

## Other Disclosures

Additional Information Available Upon Request

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