

Equity Research

February 20, 2018

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SQ

\$44.11

12 month target

\$30.00

SELL

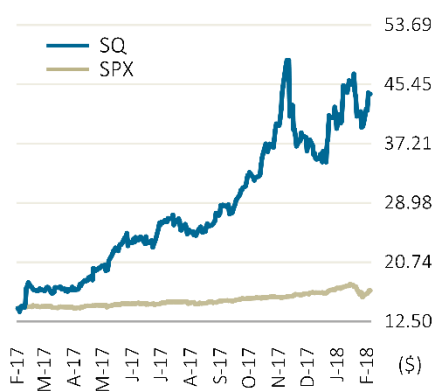
52 week range

\$14.47 - \$48.86

Market Cap (m)

\$16,936

Price Performance



Source: IDC

Financials

Square Inc.

SQ Still Trading in Step with Bitcoin as 4Q17 Report Nears; Stiffer Competition for Larger Sellers Looms

Based on a look at the charts of Square Inc. (SQ) and Bitcoin since SQ CEO Jack Dorsey on January 31 disclosed that instant buying and selling of the cryptocurrency was available to most of the company's Cash App customers – it had been available to a small number of the app's users on a trial basis since mid-November – the trajectory of SQ shares appears to have been a muted version of Bitcoin's wild ride during the past few weeks.

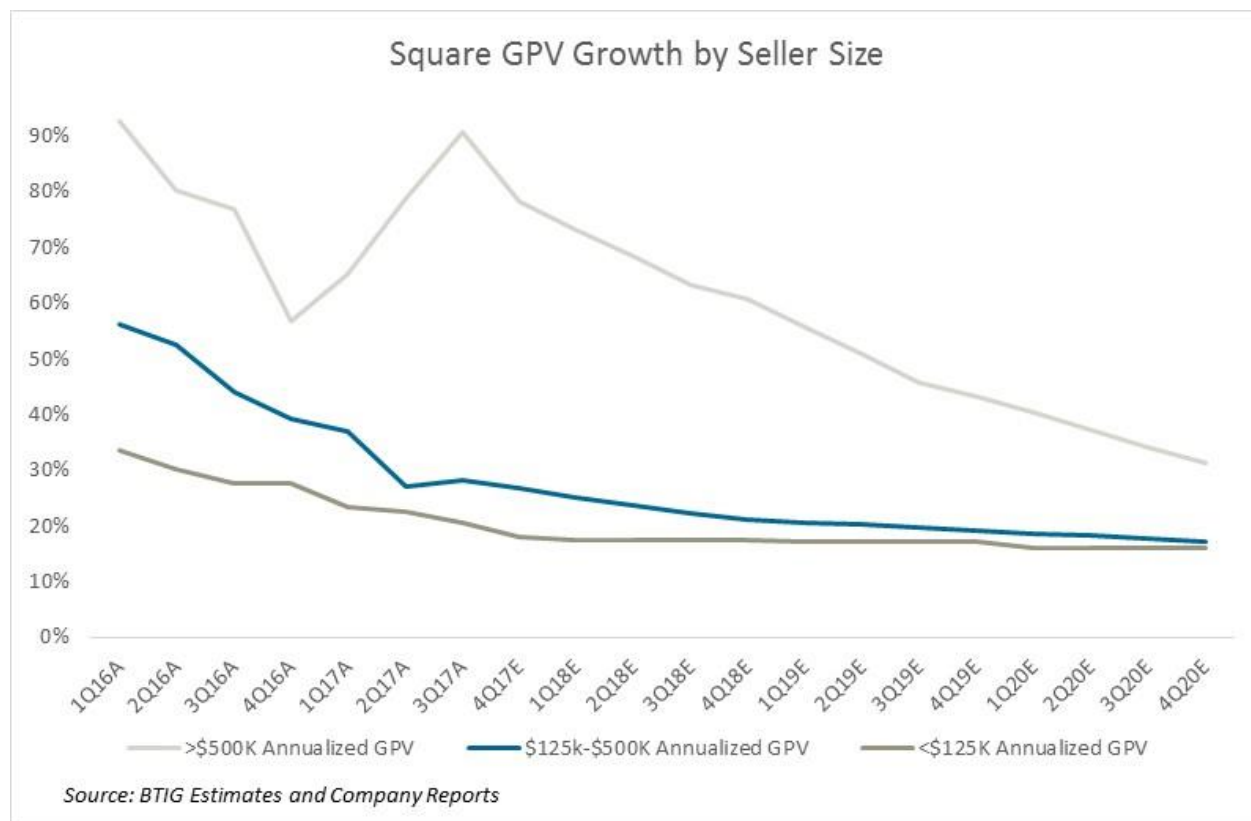
- ▶ While that connection seems to have worked to SQ's benefit during the latter portion of that ride given that Bitcoin has been rallying, it served as confirmation that SQ's stock has become tethered to the movements of a volatile cryptocurrency – a live-with-it, die-with-it relationship that we do not believe is conducive to the sustenance of a lofty multiple.
- ▶ We have been somewhat surprised by the extent to which the relationship between SQ's stock price and its involvement with Bitcoin has developed insofar as we view the contribution from the Cash App/Bitcoin offering to the company's near-to-medium term operating performance as marginal. However irrational this may be, the fact remains that for almost three months the SQ narrative has been conflated with the Bitcoin narrative despite the latter's likely minimal real impact on the former.
- ▶ With that said, all of the Bitcoin-driven fluctuations in SQ's stock price have occurred since the company reported its 3Q17 results on November 8, and the release of its 4Q17 report next Thursday likely will refocus investors on its core story.
- ▶ Our Sell rating on SQ is based less on the Bitcoin connection and more on our view that, with the stock trading at almost 26x consensus FY20E adjusted EBITDA, its valuation already reflects unimpeded rapid growth when competitive, credit-related and macro factors that could moderate the pace of its expansion remain very much in play.
- ▶ **Valuation:** Our \$30 price target for SQ is based on 20x our FY20E adjusted EBITDA of \$610mm. We believe the company's current multiple is at risk given competitive, credit- and macro-related factors. The multiple we employ is based on comparable company analysis.

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 | 2,795 |
| EBITDA (Adj.) | (8) | 13 | 12 | 30 | 46 | 27 | 36 | 34 | 36 | 134 | 234 |

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

Please Read: Important disclosures and analyst's certification appear in Appendix



- ▶ With larger sellers representing about 48% of SQ's GPV during 3Q17, the stakes are rising around the company's efforts to win in this space. What has been particularly impressive in recent quarters has been SQ's push "upmarket" to serve sellers with more than \$125K in annual gross payment volume (GPV) without any compression in transaction margin.
- ▶ Management explained that SQ's ability to drive transaction-based profit of 1.05% in 3Q17, up from 1.01% in the prior-year period, was based on the pricing pressure from custom pricing for larger sellers being offset by the contribution of higher-yielding products such as Virtual Terminal and Invoices.
- ▶ As seen in the chart above, SQ's recent growth rate among the micro-merchants which have been its core niche historically is slower than the growth it has seen among larger sellers. As such, we believe the company's overall growth trajectory will hinge in large part on its ability to sustain growth among such larger firms, a group that has traditionally been served by merchant acquirers and other payment processors.
- ▶ As SQ pushes upmarket, one competitor we believe it is likely to encounter again and again is First Data (FDC, Buy, \$23 PT) which has occupied the space for some time but had struggled to gain traction until recently. FDC's Clover and Clover Go are the company's answers to SQ's offerings, and FDC CEO Frank Bisignano during a meeting

with sell-side analysts following the release of its 4Q17 report last Monday stated that “we are maniacally focused on beating” SQ.

- ▶ Just as SQ’s strategy involves cross-selling ancillary products to its core payment processing customers and thereby generating incremental revenues while reducing churn, FDC has been busy in recent months integrating two of the acquisitions that it made during 2017 – CardConnect and BluePay – including combining them with Clover as a fully integrated offering. Bisignano noted during FDC’s 4Q17 conference call that excluding Clover Go – its mobile credit-card reader – the company had shipped over 400,000 Clover units, and including Clover Go it had shipped over 750,000 units.
- ▶ Expert reviews of SQ’s point-of-sale offerings versus those of FDC/Clover are inconclusive with pros and cons offered for each, and SQ’s ancillary products have positioned the company to maintain rapid revenue growth and transaction-based profit during its push upstream. We do not believe FDC has to beat SQ all of the time or even most of the time for it to have an impact on the trajectory of SQ’s growth among larger sellers for which the firms compete.
- ▶ One way that SQ likely will seek to keep or attract larger sellers amidst a more competitive environment is through Square Capital, which provides loans to merchants who use the company’s payment processing services. While SQ holds only a small portion of the loans it originates, we believe that as the company becomes increasingly dependent on credit as a means of driving its growth that it will also become increasingly vulnerable to credit-market volatility.
- ▶ In this regard, we believe Square Capital’s business model is akin to that of LendingClub Corporation (LC, Buy, \$7 PT) which, during the markets’ volatile start to 2016, demonstrated that a non-bank lender that sells the loans it originates can see its valuation hit just as hard by bumpiness in the credit market as those that retain loans on their balance sheets.
- ▶ Of course, SQ is seeking to transition from being a non-bank lender to the holder of an industrial loan charter (ILC) as early last September it submitted an application to Utah’s banking regulator. We see the outcome of the application process as something of a lose-lose proposition for SQ. If the company is granted an ILC, that would make credit a more central part of its story, which we believe could impair its credit-risk profile and ultimately result in multiple contraction. However, if SQ is rejected in its effort to gain an ILC, investors who cheered the announcement of a potential driver of the expansion of Square Capital are likely to be disappointed.
- ▶ Even as the company’s overall revenue growth accelerated to 45% during 3Q17 thanks in part to improved take rates, Square Capital’s growth declined sequentially for the first time ever, a drop that management attributed to seasonality and the impact of Hurricanes Harvey and Irma during the quarter. As such, we believe investors will be looking for a reacceleration from the unit when the company

reports its 4Q17 results. We believe they should be careful what they wish for.

- ▶ SQ is scheduled to report its 4Q17 results on Tuesday, February 27 after the market close with a conference call slated for 5pm ET.

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 | 504.25 | 610.79 | 643.24 | 645.74 | 2,404.01 | 2,991.67 | 3,625.60 |
| 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 | 70.93 | 83.36 | 87.85 | 99.34 | 341.47 | 453.36 | 601.47 |
| 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 |
| Total net revenue | 203.45 | 552.43 | 850.19 | 1,267.12 | 1,708.72 | 461.55 | 551.51 | 585.16 | 598.13 | 2,196.35 | 585.99 | 706.49 | 743.19 | 759.82 | 2,795.50 | 3,502.54 | 4,290.33 |
| Transaction costs | 126.35 | 277.83 | 450.86 | 672.67 | 943.20 | 257.78 | 311.09 | 328.04 | 335.60 | 1,232.51 | 330.94 | 401.55 | 423.62 | 426.01 | 1,582.13 | 1,987.80 | 2,432.28 |
| 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 | 21.46 | 25.22 | 26.58 | 30.06 | 103.33 | 130.39 | 166.97 |
| 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 |
| Total cost of revenue | 138.90 | 423.65 | 624.12 | 897.09 | 1,132.68 | 288.12 | 344.08 | 366.54 | 375.10 | 1,373.85 | 366.67 | 442.90 | 466.14 | 475.00 | 1,750.72 | 2,193.32 | 2,679.76 |
| Gross profit (loss) | 64.55 | 128.79 | 226.07 | 370.03 | 576.04 | 173.43 | 207.43 | 218.62 | 223.03 | 822.50 | 219.33 | 263.59 | 277.05 | 284.82 | 1,044.78 | 1,309.22 | 1,610.57 |
| Product development | 46.57 | 82.86 | 144.64 | 199.64 | 268.54 | 68.58 | 78.13 | 82.55 | 84.23 | 313.48 | 81.05 | 95.95 | 99.08 | 99.40 | 375.49 | 435.48 | 490.59 |
| Sales and marketing | 56.65 | 64.16 | 112.58 | 145.62 | 173.88 | 49.90 | 59.92 | 66.53 | 68.01 | 244.36 | 65.46 | 77.50 | 80.04 | 80.31 | 303.31 | 352.05 | 396.96 |
| 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 | 279.19 | 284.81 |
| Transaction and advance losses | 10.51 | 15.33 | 24.08 | 54.01 | 51.24 | 11.89 | 18.40 | 19.89 | 20.19 | 70.38 | 18.17 | 22.05 | 23.26 | 23.39 | 86.87 | 108.86 | 132.86 |
| 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 | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Total operating expenses | 149.91 | 233.73 | 376.57 | 544.49 | 746.49 | 187.51 | 219.65 | 233.51 | 238.67 | 879.34 | 231.58 | 263.08 | 270.63 | 272.03 | 1,037.33 | 1,175.58 | 1,305.22 |
| Operating income (loss) | (85.36) | (104.94) | (150.49) | (174.46) | (170.45) | (14.08) | (12.22) | (14.89) | (15.64) | (56.84) | (12.26) | 0.51 | 6.42 | 12.78 | 7.45 | 133.64 | 305.35 |
| EBITDA | (81.78) | (96.67) | (131.91) | (146.83) | (132.71) | (4.64) | (3.10) | (5.81) | (3.68) | (17.23) | (0.54) | 14.64 | 21.28 | 27.98 | 63.36 | 203.69 | 391.16 |
| Adjusted EBITDA | (70.58) | (51.53) | (67.74) | (41.12) | 45.74 | 27.03 | 36.50 | 34.30 | 35.76 | 133.58 | 35.17 | 57.69 | 66.57 | 74.28 | 233.72 | 399.62 | 609.70 |
| 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) | - | - | - | - | - | - | - | - | - | - | - | - |
| Income (loss) before income taxes | (85.20) | (103.98) | (152.65) | (176.07) | (169.67) | (14.58) | (15.49) | (16.74) | (16.14) | (62.96) | (12.76) | 0.01 | 5.92 | 12.28 | 5.45 | 131.64 | 303.35 |
| Provision for income taxes | - | 0.51 | 1.44 | 3.75 | 1.92 | 0.51 | 0.47 | (0.65) | - | 0.33 | - | - | - | - | - | - | - |
| Net income (loss) | (85.20) | (104.49) | (154.09) | (179.82) | (171.59) | (15.09) | (15.96) | (16.10) | (16.14) | (63.29) | (12.76) | 0.01 | 5.92 | 12.28 | 5.45 | 131.64 | 303.35 |
| Adjusted EPS - Diluted | | | | (0.39) | 0.04 | 0.05 | 0.08 | 0.08 | 0.06 | 0.28 | 0.06 | 0.11 | 0.13 | 0.14 | 0.45 | 0.75 | 1.10 |
| Shares outstanding - diluted | | | | 170.50 | 362.58 | 366.74 | 376.36 | 383.95 | 391.63 | 379.67 | 399.46 | 407.45 | 415.60 | 423.91 | 411.61 | 445.54 | 482.26 |
| Total net revenue | 203.45 | 552.43 | 850.19 | 1,267.12 | 1,708.72 | 461.55 | 551.51 | 585.16 | 598.13 | 2,196.35 | 585.99 | 706.49 | 743.19 | 759.82 | 2,795.50 | 3,502.54 | 4,290.33 |
| 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 | 330.94 | 401.55 | 423.62 | 426.01 | 1,582.13 | 1,987.80 | 2,432.28 |
| Adjusted revenue | 67.63 | 160.14 | 276.31 | 452.17 | 686.62 | 203.78 | 240.41 | 257.12 | 262.54 | 963.84 | 255.05 | 304.93 | 319.57 | 333.81 | 1,213.37 | 1,514.74 | 1,858.05 |
| Net income (loss) | (85.20) | (104.49) | (154.09) | (179.82) | (171.59) | (15.09) | (15.96) | (16.10) | (16.14) | (63.29) | (12.76) | 0.01 | 5.92 | 12.28 | 5.45 | 131.64 | 303.35 |
| 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 | 35.71 | 43.05 | 45.29 | 46.30 | 170.36 | 195.93 | 218.55 |
| Depreciation and amortization | 3.58 | 8.27 | 18.59 | 27.63 | 37.75 | 9.44 | 9.13 | 9.09 | 11.96 | 39.61 | 11.72 | 14.13 | 14.86 | 15.20 | 55.91 | 70.05 | 85.81 |
| 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 | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Adjusted EBITDA | (70.58) | (51.53) | (67.74) | (41.12) | 45.74 | 27.03 | 36.50 | 34.30 | 35.76 | 133.58 | 35.17 | 57.69 | 66.57 | 74.28 | 233.72 | 399.62 | 609.70 |
| 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% | 25.2% | 26.8% | 24.3% | 27.1% | 25.9% | 24.8% | 22.7% |
| Transaction revenue growth | - | 123.6% | 63.2% | 48.4% | 38.6% | 34.3% | 32.1% | 31.3% | 27.3% | 31.0% | 25.0% | 26.7% | 26.1% | 26.1% | 26.0% | 24.4% | 21.2% |
| Software and data product growth | - | - | - | 381.6% | 123.0% | 106.2% | 99.0% | 84.2% | 81.7% | 90.9% | 44.6% | 40.9% | 35.0% | 34.9% | 38.3% | 32.8% | 32.7% |
| 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% | -21.3% | -21.3% | -428.5% | 190.7% | 195.1% | 20.0% | 192.0% | 30.1% | 58.1% | 94.1% | 107.7% | 75.0% | 71.0% | 52.6% |
| Adjusted EBITDA margin | -104.4% | -32.2% | -24.5% | -9.1% | 6.7% | 13.3% | 15.2% | 13.3% | 13.6% | 13.9% | 13.8% | 18.9% | 20.8% | 22.3% | 19.3% | 26.4% | 32.8% |

Source: BTIG Estimates and Company Reports

BTIG Covered Companies Mentioned in this Report

SQUARE INC. (SQ, Sell, \$30.00 PT; Current Price: \$44.11; Analyst: Mark.Palmer)

FIRST DATA CORPORATION (FDC, Buy, \$23.00 PT; Current Price: \$15.66; 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.

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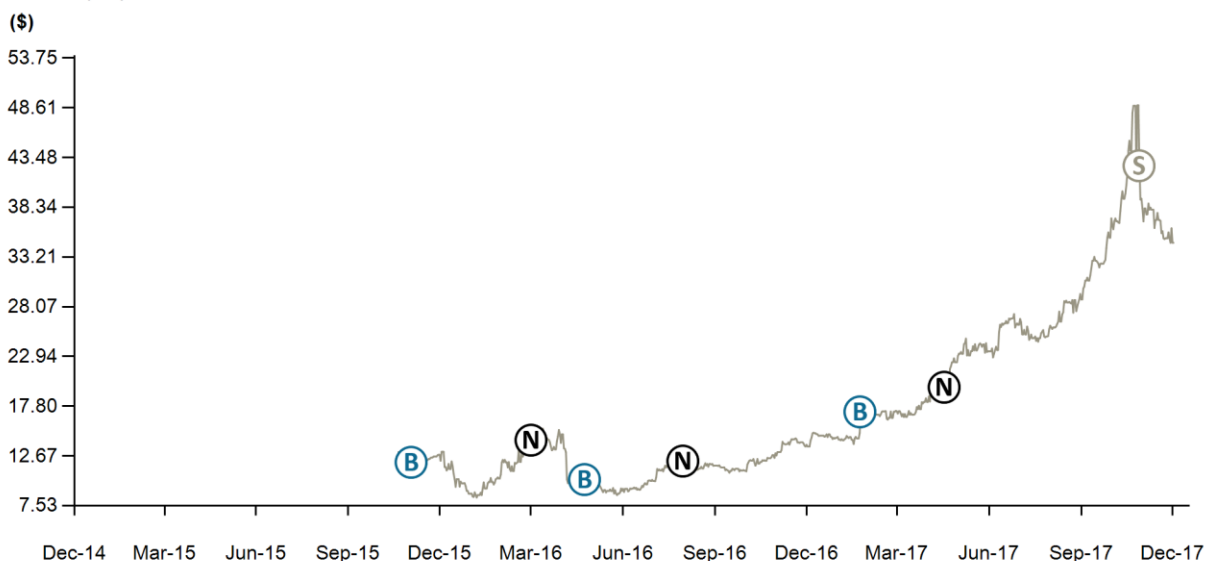
Company Valuation and Risk Disclosures

Square Inc. (SQ, Sell, \$30.00 PT)

Valuation: Our \$30 price target for SQ is based on 20x our FY20E adjusted EBITDA of \$610mm. We believe the company's current multiple is at risk given competitive, credit- and macro-related factors. The multiple we employ is based on comparable company analysis.

Risks: The primary Upside risks include, better than anticipated performance by the company, rapid growth, continued multiple expansion, Square's ability to launch new lines of business, the company's ability to expand into additional countries to continue their rapid growth 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 |
| 27-Nov-17 | 42.55 | 30 | Mark Palmer | Sell |

Other Disclosures

Additional Information Available Upon Request

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