

## Equity Research

May 2, 2018

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## Financials

### Square Inc.

#### 1Q18 Beat-and-Raise Overshadowed by New AMZN Threat, Weak 2Q18 EPS Guidance and Lofty Valuation

While Square (SQ) today after the market close released a 1Q18 report featuring the company's latest quarterly adjusted EBITDA beat and full-year guidance raise in terms of net and adjusted revenue and adjusted earnings per share, the initial reaction of SQ shares was to move lower. We believe that apparent disconnect can be attributed to three primary factors, with a fourth factor perhaps having some impact as well.

- ▶ First, less than two hours before SQ released its 1Q18 report the payment space was shaken by a media report that Amazon (AMZN, Not Rated) in an effort to expand adoption of its online payments service, Amazon Pay, had offered to pass through the discounts it receives on credit-card swipe fees to other retail merchants. The report emerged just days after SQ announced its acquisition of Weebly, a website creation platform, which the company framed as part of its effort to push from in-person payments to omnichannel commerce. In that regard, a more robust push by AMZN into the online payments space is bound to be viewed as a potential headwind for SQ, in our view.
- ▶ Second, management's offered 2Q18 guidance for SQ's adjusted revenue in a range of \$355mm to \$360mm, the lower end of which exceeded the consensus estimate of \$335mm. However, the upper end of management's 2Q18 adjusted EPS guidance of \$0.09 to \$0.11 was below the consensus estimate of \$0.12.
- ▶ Third, SQ's lofty valuation – the stock trades at 29x FY20E adjusted EBITDA – has baked into it such high expectations that a report featuring a solid beat-and-raise and attractive volume and revenue growth rates may no longer be sufficient to spark additional share price appreciation, in our view. As such, **we are reiterating our Sell recommendation on SQ and price target of \$30** based on 20x our FY20E adjusted EBITDA of \$662mm.
- ▶ **Valuation:** Our \$30 price target for SQ is based on 20x our FY20E adjusted EBITDA of \$662mm. 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.

**SQ** **\$48.66**

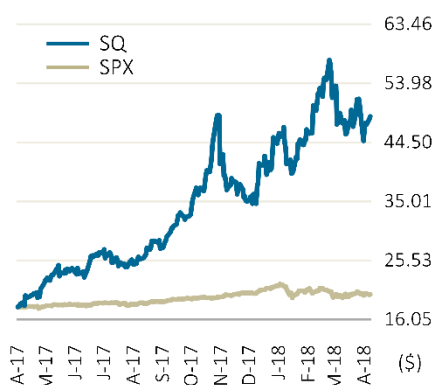
12 month target \$30.00

### SELL

52 week range \$18.28 - \$57.69

Market Cap (m) \$21,931

#### Price Performance



Source: IDC

## Estimates

	1Q17 A	2Q17 A	3Q17 A	4Q17 A	FY17 A	1Q18 A	2Q18 E	3Q18 E	4Q18 E	FY18 E	FY19 E
Sales	462	552	585	616	2,214	669	756	792	811	2,993	3,802
EBITDA (Adj.)	27	36	34	41	139	36	64	74	75	249	434

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

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

- ▶ Another factor that may have weighed on SQ's share price during extended trading earlier today was the company's disclosure of the contribution to its operating results from its facilitation of buying and selling of bitcoin on its Square Cash app, a feature that was made available to most of the app's users on January 31. Inasmuch as SQ's stock performance in recent months has been bolstered by enthusiasm surrounding the bitcoin effort, the actual financial impact of the cryptocurrency on the company's results provided a window into how little such transactions may move the needle for the company.
- ▶ SQ reported that \$34.1mm of the \$669mm in total net revenue it generated during 1Q18 was derived from bitcoin. At the same time, the costs associated with purchasing the cryptocurrency prior to selling it were \$33.9mm. The upshot was that bitcoin contributed a total of \$0.2mm of the \$307mm of the adjusted revenue that the company posted during the quarter.
- ▶ While we acknowledge that SQ had only two months of contribution from bitcoin after the full launch of the effort, we also believe the initial figures demonstrated just how dramatic a ramp in bitcoin volumes would be required before the initiative would contribute in a meaningful way to the company's operating performance.
- ▶ SQ's total net revenue grew during 1Q18 by 45% versus the prior year period. At the same time, the company's year-over-year revenue growth from sellers that generate less than \$125K in annual gross payment volume (GPV) – a group that represented 53% of its GPV during the quarter – was 21.7%. As such, we believe the stakes are rising around SQ's efforts to push "upmarket" to serve sellers with more than \$125K in annual GPV without any compression in transaction margin even as it is bound to face more competition in that space.
- ▶ SQ's subscription and services-based revenue increased by 98% year-over-year to \$97mm with growth paced by Instant Deposit, Caviar and Square Capital. While Square Capital's loan volume had seemed to plateau in 4Q17 as it had been essentially flat on a sequential basis, it reaccelerated during 1Q18 by 35% versus the prior year period to \$339mm.
- ▶ We continue to view the expansion of Square Capital as something of a double-edged sword. While it has provided SQ's closely-watched subscription and services-based revenue line item with a boost in the near-term, we believe that if the company becomes increasingly dependent on credit as a means of driving its growth and reducing its churn, particularly among the larger merchants that represent its fastest-growing segment, it will also become increasingly vulnerable to credit-market volatility. As such, we view the continued expansion of Square Capital – including the potential expansion of the platform if SQ is successful in its pursuit of an

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industrial loan company (ILC) charter – as a negative for the company’s risk profile.

- ▶ SQ reported 1Q18 adjusted EBITDA of \$36mm, exceeding the consensus estimate of \$33.8mm and our estimate of \$34.3mm. The company during the quarter posted adjusted EPS of \$0.06, matching the consensus estimate as well as our estimate.
- ▶ SQ’s gross payment volume (GPV) increased by 31% during 1Q18 to \$17.8bn.

## 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	4Q17A	2017A	1Q18A	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	524.61	1,920.17	523.04	632.68	664.80	671.37	2,491.89	3,174.30	3,997.56
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	79.40	252.66	97.05	106.48	111.24	120.09	434.86	524.69	590.05
Hardware revenue	-	4.24	7.32	16.38	44.31	9.02	10.29	10.09	12.02	41.42	14.42	16.45	16.13	19.22	66.22	102.58	153.78
Bitcoin revenue	-	-	-	-	-	-	-	-	-	-	34.10	-	-	-	34.10	-	-
Total net revenue	203.45	552.43	850.19	1,267.12	1,708.72	461.55	551.51	585.16	616.04	2,214.25	668.60	755.61	792.18	810.68	2,992.98	3,801.57	4,741.39
Transaction costs	126.35	277.83	450.86	672.67	943.20	257.78	311.09	328.04	333.38	1,230.29	327.91	400.90	421.75	426.42	1,576.98	2,016.16	2,540.23
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	24.56	75.72	30.37	34.77	36.33	39.22	140.69	163.48	177.95
Hardware cost	-	6.01	18.33	30.87	68.56	12.66	14.17	18.78	16.78	62.39	19.70	19.08	18.71	22.11	79.61	117.97	169.16
Bitcoin costs	-	-	-	-	-	-	-	-	-	-	33.87	-	-	-	33.87	-	-
Amortization of acquired technology	-	-	1.00	5.64	8.03	1.81	1.70	1.56	1.49	6.54	1.58	1.66	1.74	1.83	6.81	8.28	10.06
Total cost of revenue	138.90	423.65	624.12	897.09	1,132.68	288.12	344.08	366.54	376.21	1,374.95	413.43	456.42	478.54	489.57	1,837.96	2,305.90	2,897.40
Gross profit (loss)	64.55	128.79	226.07	370.03	576.04	173.43	207.43	218.62	239.83	839.31	255.17	299.19	313.64	321.11	1,155.02	1,495.67	1,843.99
Product development	46.57	82.86	144.64	199.64	268.54	68.58	78.13	82.55	92.63	321.89	105.10	113.49	115.22	120.17	453.98	526.42	593.97
Sales and marketing	56.65	64.16	112.58	145.62	173.88	49.90	59.92	66.53	76.82	253.17	77.27	89.33	92.91	96.00	355.51	436.85	520.97
General and administrative	36.18	68.94	94.22	143.47	251.99	56.94	62.99	64.31	66.32	250.55	75.50	76.26	77.02	77.79	306.56	315.06	319.41
Transaction and advance losses	10.51	15.33	24.08	54.01	51.24	11.89	18.40	19.89	16.83	67.02	18.03	21.87	23.02	23.28	86.20	110.33	139.42
Amortization of acquired customer assets	-	-	1.05	1.76	0.85	0.21	0.22	0.22	0.23	0.88	0.27	-	-	-	0.27	-	-
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	252.84	893.51	276.16	300.94	308.17	317.24	1,202.51	1,388.66	1,573.78
Operating income (loss)	(85.36)	(104.94)	(150.49)	(174.46)	(170.45)	(14.08)	(12.22)	(14.89)	(13.01)	(54.21)	(20.99)	(1.75)	5.47	3.87	(47.50)	107.01	270.22
EBITDA	(81.78)	(96.67)	(131.91)	(146.83)	(132.71)	(4.64)	(3.10)	(5.81)	(3.38)	(16.93)	(10.83)	8.89	16.58	15.40	30.04	160.57	336.25
Adjusted EBITDA	(70.58)	(51.53)	(67.74)	(41.12)	45.74	27.03	36.50	34.30	41.18	139.01	35.89	63.91	74.04	75.00	248.85	434.02	662.36
Interest (income) and expense	0.01	(0.01)	1.06	1.16	(0.24)	0.50	3.27	1.85	2.84	8.46	2.82	0.50	0.50	0.50	4.32	4.00	6.00
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)	(15.85)	(62.66)	(23.81)	(2.25)	4.97	3.37	(51.82)	103.01	264.22
Provision for income taxes	-	0.51	1.44	3.75	1.92	0.51	0.47	(0.65)	(0.19)	0.15	0.18	-	-	-	0.18	-	-
Net income (loss)	(85.20)	(104.49)	(154.09)	(179.82)	(171.59)	(15.09)	(15.96)	(16.10)	(15.66)	(62.81)	(23.99)	(2.25)	4.97	3.37	(51.99)	103.01	264.22
Adjusted EPS - Diluted				(0.39)	0.04	0.05	0.08	0.08	0.08	0.27	0.06	0.13	0.15	0.15	0.41	0.82	1.21
Shares outstanding - diluted				170.50	362.58	366.74	376.36	383.95	450.70	426.52	461.76	466.38	471.04	475.75	468.73	488.50	509.84
Total net revenue	203.45	552.43	850.19	1,267.12	1,708.72	461.55	551.51	585.16	616.04	2,214.25	668.60	755.61	792.18	810.68	2,992.98	3,801.57	4,741.39
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	333.38	1,230.29	327.91	400.90	421.75	426.42	1,576.98	2,016.16	2,540.23
Bitcoin costs	-	-	-	-	-	-	-	-	-	-	33.87	-	-	-	33.87	-	-
Adjusted revenue	67.63	160.14	276.31	452.17	686.62	203.78	240.41	257.12	282.66	983.96	306.82	354.71	370.42	384.27	1,382.13	1,785.41	2,201.16
Net income (loss)	(85.20)	(104.49)	(154.09)	(179.82)	(171.59)	(15.09)	(15.96)	(16.10)	(15.66)	(62.81)	(23.99)	(2.25)	4.97	3.37	(17.90)	103.01	264.22
Starbucks transaction revenue	(9.47)	(114.46)	(123.02)	(142.28)	(78.90)	-	-	-	-	(62.81)	(23.99)	(2.25)	-	-	-	-	-
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	44.53	155.84	46.82	55.02	57.46	59.60	218.90	273.45	326.11
Depreciation and amortization	3.58	8.27	18.59	27.63	37.75	9.44	9.13	9.09	9.63	37.28	10.16	10.64	11.11	11.53	43.44	53.56	66.03
Interest (income) expense	0.01	(0.01)	1.06	1.16	(0.24)	0.50	3.27	1.85	2.84	8.46	2.82	0.50	0.50	0.50	4.32	4.00	6.00
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)	(0.19)	0.15	0.18	-	-	-	0.18	-	-
Loss on sale of property plant and equipment	0.01	2.71	0.11	0.27	(0.05)	-	0.00	0.06	0.04	0.10	(0.10)	-	-	-	(0.10)	-	-
Impairment of intangible assets	-	2.43	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Adjusted EBITDA	(70.58)	(51.53)	(67.74)	(41.12)	45.74	27.03	36.50	34.30	41.18	139.01	35.89	63.91	74.04	75.00	248.85	434.02	662.36
Tax rate	-	-0.5%	-0.9%	-2.1%	-1.1%	-3.5%	-3.0%	3.9%	1.2%	-0.2%	-0.7%	0.0%	0.0%	0.0%	-0.3%	0.0%	0.0%
Adjusted revenue growth	-	136.8%	72.5%	63.6%	51.9%	39.4%	40.7%	44.6%	47.3%	43.3%	50.6%	47.5%	44.1%	35.9%	40.5%	29.2%	23.3%
Transaction revenue growth	-	123.6%	63.2%	48.4%	38.6%	34.3%	32.1%	31.3%	30.3%	31.9%	29.6%	31.2%	30.3%	28.0%	29.8%	27.4%	25.9%
Software and data product growth	-	-	-	381.6%	123.0%	106.2%	99.0%	84.2%	96.0%	95.3%	97.8%	80.0%	71.0%	51.2%	72.1%	20.7%	12.5%
Hardware revenue growth	-	-	72.7%	123.6%	170.5%	-44.3%	-7.2%	23.5%	35.5%	-6.5%	59.9%	59.9%	59.9%	59.9%	59.9%	54.9%	49.9%
EBITDA Margin	-120.9%	-60.4%	-47.7%	-32.5%	-19.3%	-2.3%	-1.3%	-2.3%	-1.2%	-1.7%	-3.5%	2.5%	4.5%	4.0%	2.2%	9.0%	15.3%
Adjusted EBITDA margin	-104.4%	-32.2%	-24.5%	-9.1%	6.7%	13.3%	15.2%	13.3%	14.6%	14.1%	11.7%	18.0%	20.0%	19.5%	18.0%	24.3%	30.1%

Source: BTIG Estimates and Company Reports

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## **BTIG Covered Companies Mentioned in this Report**

SQUARE INC. (SQ, Sell, \$30.00 PT; Current Price: \$48.66; Analyst: Mark.Palmer)

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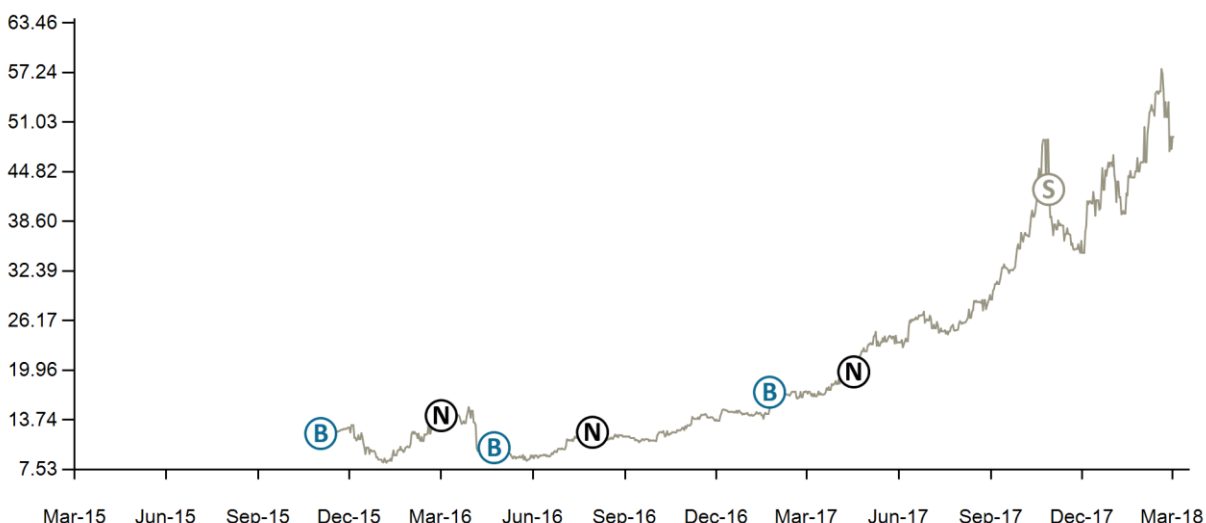
#### Square Inc. (SQ, Sell, \$30.00 PT)

**Valuation:** Our \$30 price target for SQ is based on 20x our FY20E adjusted EBITDA of \$662mm. The multiple we use reflects our anticipation of the company's continued rapid growth.

**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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