

Equity Research

February 27, 2019

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| SQ | \$79.32 |
|-----------------|-------------------|
| 12 month target | \$30.00 |
| SELL | |
| 52 week range | \$44.75 - \$99.01 |
| Market Cap (m) | \$37,282 |



Financials

Square Inc.

Higher-Than-Expected Spending = Weaker-Than-Expected 1Q19 and FY19 Outlook; Reiterating Sell

With its shares trading at what we view as a very rich multiple, Square (SQ) had little room for error heading into the release of its 4Q18 results today after the market close. While SQ delivered what has become its customary top- and bottom-line beats in 4Q18, management's guidance for 1Q19 and FY19 may have muddied the story. The culprit: higher-than-expected spending factored into SQ's forecasts as the Street appears to have underestimated the costs the company would incur in striving to sustain its growth trajectory.

- In particular, the high end of SQ's guidance for 1Q19 adjusted EBITDA in a range of \$47mm to \$51mm was well below the consensus estimate of \$70.4mm and our estimate of \$73.0mm. With regard to adjusted earnings per share, the high end of management's guidance for 1Q19 in a range of \$0.06 to \$0.08 was below the consensus estimate of \$0.11 and our estimate of \$0.14.
- At the same time, the high end of SQ's guidance for FY19 adjusted EBITDA in a range of \$405mm to \$415mm was below the consensus estimate of \$421mm and our estimate of \$432mm.
- ▶ While SQ's guidance for 1Q19 and FY19 revenue was in line with Street expectations the midpoint of its FY19 revenue guidance would represent year-over-year growth of 41%, consistent with the soft guidance that management had provided in November its lower-than-expected bottom-line forecast was due to an increase in spending on newer services outside of its core payment-processing business.
- ► We are reiterating our Sell recommendation on SQ and price target of \$30 based on 20x our FY20E adjusted EBITDA of \$694mm. We view SQ shares as very expensive at 48.6x FY20E adjusted EBITDA.
- Valuation: Our \$30 price target for SQ is based on 20x our FY20E adjusted EBITDA of \$694mm. The multiple we use reflects our anticipation of the company's continued growth, albeit at a slower rate than its valuation currently implies.

Estimates

| | 1Q18 A | 2Q18 A | 3Q18 A | 4Q18 A | FY18 A | 1Q19 E | 2Q19 E | 3Q19 E | 4Q19 E | FY19 E | FY20 E |
|---------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Sales | 669 | 815 | 882 | 933 | 3,298 | 934 | 1,087 | 1,135 | 1,164 | 4,322 | 5,327 |
| EBITDA (Adj.) | 36 | 65 | 71 | 81 | 254 | 51 | 110 | 119 | 133 | 414 | 694 |

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



- ▶ While SQ's first quarter traditionally has been impacted by seasonality, the midpoint of the company's 1Q19 adjusted EBITDA guidance would imply a margin of 10.3% that would be down from 11.7% in the prior year period. Management explained during today's conference call that SQ was deliberately spending more earlier in the year this year as a means of spurring growth later in the year.
- ▶ A highlight of SQ's 4Q18 report was the company's disclosure that its Cash App had 15mm monthly active customers in December 2018, more than twice the number it had a year earlier. Management would not disclose the extent to which it had been able to monetize the app while noting that the app would take revenue through Instant Deposit, Cash Card, peer-to-peer transactions and cryptocurrency.
- ▶ Square Capital during 4Q18 facilitated over 72,000 business loans for a total of \$472mm, a 55% increase versus the prior year period. At the same time, Square Installments, the company's new purchase financing product, during the quarter processed over 10mm transactions over \$250 in the U.S. These two loan product segments may boost SQ's results in the near term while reducing churn among its core payment customers, but we believe their growth will make the company increasingly dependent on credit as a means of driving its growth and therefore increasingly at risk when credit-market volatility arises.
- As such, we view the expansion of Square Capital and Square Installments as a negative for the company's risk profile that is not currently reflected in SQ's lofty multiple.
- ➤ SQ's gross payment volume (GPV) of \$23bn represented year-overyear growth of 28%. The company's GPV growth had fallen below 30% for the first time in 3Q18 when it was 29%.
- ➤ SQ reported 4Q18 adjusted revenue of \$464mm, outpacing the consensus estimate of \$455mm. The company also reported 4Q18 adjusted EBITDA of \$81mm, better than the Street estimate of \$79mm.
- ► The portion of SQ's GPV generated by larger sellers, those defined as producing more than \$125K in annualized GPV, was 51% in 4Q18, up from 47% in the prior year period. That figure includes 24% of the company's GPV represented by merchants with GPV greater than \$500K.
- We believe SQ's increasing dependence on larger sellers as a driver of its growth is an underappreciated risk factor for the company. While SQ has little competition in providing payment-processing and other services to micromerchants (among whom GPV growth has been decelerating), it will be facing increasing competition in pursuing the business of larger sellers.
- ► In particular, we believe Fiserv's (FISV, Not Rated) pending acquisition of First Data Corporation (FDC, Neutral) poses a threat to SQ's future growth among large sellers. Even before the announcement of the



- deal last month we believed that FDC's Clover and Clover Go suite of point-of-sale (POS) payment platform would represent an increasingly significant competitor to SQ in the larger-seller space as it continued to ramp up.
- ► The FISV-FDC combination is expected to generate \$4bn in free cash flow in the third year following close, and the companies announced that it will invest an incremental \$500mm over five years to accelerate growth. The upshot is that Clover and Clover Go will now be backed by a fintech giant with deep pockets that intends to accelerate the growth of the platform.



Income Statement

| Square Inc Operating Model \$ millions | Dec-14 2014A | Dec-15 2015A | Dec-16 2016A | Dec-17 2017A | Mar-18 1Q18A | Jun-18 2Q18A | Sep-18 3Q18A | Dec-18 4Q18A | Dec-18 2018A | Mar-19 1Q19E | Jun-19 2Q19E | Sep-19 3Q19E | Dec-19 4Q19E | Dec-19 2019E | Mar-20 1Q20E | Jun-20 2Q20E | Sep-20 3Q20E | Dec-20 4Q20E | Dec-20 2020E |
|--|-----------------------|-----------------------|------------------|-----------------|-----------------------|-----------------------|-----------------------|-----------------------|-------------------------|-----------------|-----------------------|-----------------------|-----------------------|-----------------|-----------------------|-----------------------|-----------------|-----------------------|-----------------|
| Transaction-based revenue | 707.80 | 1,050.45 | 1,456.16 | 1,920.17 | 523.04 | 625.23 | 655.38 | 667.80 | 2,471.45 | 662.46 | 795.95 | 838.82 | 860.57 | 3,157.79 | 839.73 | 1,009.55 | 1,063.21 | 1,084.17 | 3,996.66 |
| Starbucks transaction-based revenue | 123.02 | 142.28 | 78.90 | - 1,520:17 | 525.04 | - | - | - | 2,472.43 | - | - | - | - | 5,157.75 | - | - | - | - | - |
| Subscription and services-based revenue | 12.05 | 58.01 | 129.35 | 252.66 | 97.05 | 134.33 | 166.20 | 194.12 | 591.71 | 197.87 | 211.19 | 216.91 | 222.70 | 848.67 | 225.62 | 240.82 | 246.83 | 252.48 | 965.75 |
| Hardware revenue | 7.32 | 16.38 | 44.31 | 41.42 | 14.42 | 18.36 | 17.56 | 18.17 | 68.50 | 21.07 | 26.83 | 25.66 | 26.54 | 100.10 | 29.73 | 37.86 | 36.20 | 37.46 | 141.25 |
| Bitcoin revenue | - | - | - | - | 34.10 | 37.02 | 42.96 | 52.44 | 166.52 | 52.97 | 53.50 | 54.03 | 54.57 | 215.07 | 55.12 | 55.67 | 56.23 | 56.79 | 223.80 |
| Total net revenue | 850.19 | 1,267.12 | 1,708.72 | 2,214.25 | 668.60 | 814.94 | 882.11 | 932.53 | 3,298.18 | 934.36 | 1,087.47 | 1,135.41 | 1,164.38 | 4,321.63 | 1,150.19 | 1,343.90 | 1,402.48 | 1,430.89 | 5,327.47 |
| Transaction costs | 450.86 | 672.67 | 943.20 | 1,230.29 | 327.91 | 395.35 | 414.46 | 420.85 | 1,558.56 | 422.03 | 506.98 | 534.18 | 547.92 | 2,011.11 | 532.94 | 640.60 | 674.51 | 687.67 | 2,535.72 |
| Starbucks transaction costs | 150.96 | 165.44 | 69.76 | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Software and data products cost | 2.97 | 22.47 | 43.13 | 75.72 | 30.37 | 39.78 | 47.08 | 52.65 | 169.88 | 54.91 | 58.39 | 59.76 | 61.13 | 234.19 | 61.37 | 65.50 | 67.14 | 68.67 | 262.68 |
| Hardware cost | 18.33 | 30.87 | 68.56 | 62.39 | 19.70 | 25.54 | 23.23 | 25.65 | 94.11 | 24.23 | 30.85 | 29.50 | 30.53 | 115.11 | 32.70 | 41.65 | 39.83 | 41.20 | 155.38 |
| Bitcoin costs | | | | | 33.87 | 36.60 | 42.41 | 51.95 | 164.83 | 51.64 | 52.16 | 52.68 | 53.21 | 209.69 | 53.74 | 54.28 | 54.82 | 55.37 | 218.21 |
| Amortization of acquired technology Total cost of revenue | 1.00 624.12 | 5.64 897.09 | 8.03 1.132.68 | 6.54 | 1.58 413.43 | 1.86 499.12 | 2.28 529.45 | 1.38 552.47 | 7.09 1.994.48 | 1.44 554.26 | 1.52 649.90 | 1.59 677.71 | 1.67 694.46 | 6.23 | 1.76 682.51 | 1.84 803.87 | 1.94 838.23 | 2.03 854.95 | 7.57 |
| lotal cost of revenue | 624.12 | 897.09 | 1,132.68 | 1,374.95 | 413.43 | 499.12 | 529.45 | 552.47 | 1,994.48 | 554.26 | 649.90 | 6/7./1 | 694.46 | 2,576.33 | 682.51 | 803.87 | 838.23 | 854.95 | 3,179.56 |
| Gross profit (loss) | 226.07 | 370.03 | 576.04 | 839.31 | 255.17 | 315.82 | 352.66 | 380.05 | 1,303.70 | 380.11 | 437.56 | 457.70 | 469.93 | 1,745.30 | 467.68 | 540.03 | 564.24 | 575.94 | 2,147.90 |
| Product development | 144.64 | 199.64 | 268.54 | 321.89 | 105.10 | 114.80 | 135.77 | 141.81 | 497.48 | 155.50 | 154.21 | 162.63 | 167.30 | 639.62 | 178.01 | 178.73 | 188.46 | 192.96 | 738.15 |
| Sales and marketing | 112.58 | 145.62 | 173.88 | 253.17 | 77.27 | 98.24 | 116.34 | 119.31 | 411.15 | 116.59 | 132.23 | 135.88 | 138.10 | 522.80 | 136.75 | 157.35 | 161.47 | 163.25 | 618.82 |
| General and administrative | 94.22 | 143.47 | 251.99 | 250.55 | 75.50 | 82.77 | 85.53 | 95.45 | 339.25 | 100.22 | 101.22 | 102.23 | 104.28 | 407.94 | 104.54 | 104.80 | 105.06 | 105.32 | 419.72 |
| Transaction and advance losses | 24.08 | 54.01 | 51.24 | 67.02 | 18.03 | 21.98 | 23.60 | 24.47 | 88.08 | 26.56 | 31.92 | 33.65 | 34.53 | 126.65 | 33.73 | 40.56 | 42.73 | 43.59 | 160.60 |
| Amortization of acquired customer assets | 1.05 | 1.76 | 0.85 | 0.88 | 0.27 | 0.67 | 1.29 | 2.13 | 4.36 | - | - | - | - | - | - | - | - | - | - |
| Impairment of intangible assets Total operating expenses | 376.57 | 544.49 | 746.49 | 893.51 | 276.16 | 318.46 | 362.53 | 383.16 | 1,340.31 | 398.86 | 419.57 | 434.39 | 444.20 | 1,697.02 | 453.03 | 481.43 | 497.71 | 505.12 | 1,937.30 |
| Operating income (loss) | (150.49) | (174.46) | (170.45) | (54.21) | (20.99) | (2.65) | (9.87) | (3.11) | (36.61) | (18.75) | 17.99 | 23.31 | 25.73 | 48.27 | 14.66 | 58.60 | 66.53 | 70.82 | 210.61 |
| EBITDA | (131.91) | (146.83) | (132.71) | (16.93) | (10.83) | 9.68 | 5.97 | 19.53 | 24.35 | (2.38) | 36.74 | 42.77 | 45.71 | 122.84 | 34.66 | 81.61 | 90.39 | 95.21 | 301.86 |
| | | | | | | | | | | | | | | | | | | | |
| Adjusted EBITDA | (67.74) | (41.12) | 45.74 | 139.01 | 35.89 | 65.32 | 71.00 | 81.31 | 253.52 | 51.39 | 110.40 | 119.24 | 132.80 | 413.84 | 114.65 | 180.23 | 192.66 | 206.68 | 694.22 |
| Interest (income) and expense | 1.06 | 1.16 | (0.24) | 8.46 | 2.82 | 2.66 | 7.22 | 5.18 | 17.87 | 5.23 | 5.28 | 5.33 | 5.39 | 21.23 | 5.44 | 5.49 | 5.55 | 5.60 | 22.09 |
| Other (income) and expense | 1.10 | 0.45 | (0.54) | - 1 | - | | (37.80) | 19.44 | (18.36) | - | | | - | - 1 | - | | | - | - |
| Income (loss) before income taxes | (152.65) | (176.07) | (169.67) | (62.66) | (23.81) | (5.30) | 20.71 | (27.72) | (36.13) | (23.98) | 12.71 | 17.98 | 20.34 | 27.05 | 9.22 | 53.10 | 60.98 | 65.22 | 188.52 |
| Provision for income taxes | 1.44 | 3.75 | 1.92 | 0.15 | 0.18 | 0.60 | 1.07 | 0.48 | 2.33 | - | - | - | - | - | - | - | - | - | - |
| Net income (loss) | (154.09) | (179.82) | (171.59) | (62.81) | (23.99) | (5.91) | 19.64 | (28.20) | (38.45) | (23.98) | 12.71 | 17.98 | 20.34 | 27.05 | 9.22 | 53.10 | 60.98 | 65.22 | 188.52 |
| Adjusted EPS - Diluted | | (0.39) | 0.04 | 0.27 | 0.06 | 0.13 | 0.14 | 0.10 | 0.43 | 0.09 | 0.21 | 0.22 | 0.25 | 0.77 | 0.21 | 0.33 | 0.35 | 0.37 | 1.26 |
| Shares outstanding - diluted | | 170.50 | 362.58 | 426.52 | 461.76 | 470.02 | 474.92 | 488.18 | 478.90 | 493.06 | 496.76 | 500.48 | 504.24 | 498.63 | 508.02 | 510.56 | 513.11 | 515.68 | 511.84 |
| Total net revenue | 850.19 | 1,267.12 | 1,708.72 | 2,214.25 | 668.60 | 814.94 | 882.11 | 932.53 | 3,298.18 | 934.36 | 1,087.47 | 1,135.41 | 1,164.38 | 4,321.63 | 1,150.19 | 1,343.90 | 1,402.48 | 1,430.89 | 5,327.47 |
| Starbucks transaction revenue | 123.02 | 142.28 | 78.90 | 2,214.23 | - | - | | - | | - | - 1,007.47 | | - | -,521.03 | 1,130.13 | | 1,402.40 | - | - 3,327.47 |
| Transaction costs | 450.86 | 672.67 | 943.20 | 1,230.29 | 327.91 | 395.35 | 414.46 | 420.85 | 1,558.56 | 422.03 | 506.98 | 534.18 | 547.92 | 2,011.11 | 532.94 | 640.60 | 674.51 | 687.67 | 2,535.72 |
| Bitcoin costs | - | - | - | | 33.87 | 36.60 | 42.41 | 51.95 | 164.83 | 51.64 | 52.16 | 52.68 | 53.21 | 209.69 | 53.74 | 54.28 | 54.82 | 55.37 | 218.21 |
| Deferred revenue adjustment | - | - | - | r - 1 | - | 2.44 | 5.89 | 4.52 | 12.85 | 6.93 | 7.39 | 7.59 | 7.79 | 29.70 | 7.90 | 8.43 | 8.64 | 8.84 | 33.80 |
| Adjusted revenue | 276.31 | 452.17 | 686.62 | 983.96 | 306.82 | 385.43 | 431.14 | 464.25 | 1,587.64 | 467.61 | 535.72 | 556.15 | 571.05 | 2,130.53 | 571.41 | 657.46 | 681.78 | 696.69 | 2,607.34 |
| Net income (loss) | (154.09) | (179.82) | (171.59) | (62.81) | (23.99) | (5.91) | 19.64 | (28.20) | (38.45) | (23.98) | 12.71 | 17.98 | 20.34 | 27.05 | 9.22 | 53.10 | 60.98 | 65.22 | 188.52 |
| Starbucks transaction revenue | (123.02) | (142.28) | (78.90) | (52.51) | (23.33) | - (5.51) | | - (20:20) | - (55.45) | - (23.30) | | | - | | - | - | - | - | |
| Starbucks transaction costs | 150.96 | 165.44 | 69.76 | | - | | | - | - | - | | | - | - | - | | | - | - |
| Share-based compensation expense | 36.12 | 82.29 | 138.79 | 155.84 | 46.82 | 52.12 | 58.91 | 59.03 | 216.88 | 53.78 | 73.66 | 76.47 | 87.08 | 290.99 | 80.00 | 98.62 | 102.27 | 111.47 | 392.35 |
| Depreciation and amortization | 18.59 | 27.63 | 37.75 | 37.28 | 10.16 | 12.33 | 15.84 | 22.64 | 60.96 | 16.37 | 18.75 | 19.47 | 19.99 | 74.57 | 20.00 | 23.01 | 23.86 | 24.38 | 91.26 |
| Interest (income) expense | 1.06 | 1.16 | (0.24) | 8.46 | 2.82 | 2.66 | 7.22 | 5.18 | 17.87 | 5.23 | 5.28 | 5.33 | 5.39 | 21.23 | 5.44 | 5.49 | 5.55 | 5.60 | 22.09 |
| Other (income) expense | 1.10 | 0.45 | 48.32 | - | - * | 3.45 | (37.80) | 19.44 | (14.91) | - | - | - | - | - | - | - | - | - | - |
| Provision (benefit) for income taxes | 1.44 | 3.75 | 1.92 | 0.15 | 0.18 | 0.60 | 1.07 | 0.48 | 2.33 | - | - | - | - | - | - | | - | - | - |
| Loss on sale of property plant and equipment Other | 0.11 | 0.27 | (0.05) | 0.10 | (0.10) | 0.07 | 0.81 5.31 | 2.76 | 0.78 8.07 | - | - | - | - | - | - | - | - | - | - |
| Adjusted EBITDA | (67.74) | (41.12) | 45.74 | 139.01 | 35.89 | 65.32 | 71.00 | 81.31 | 253.52 | 51.39 | 110.40 | 119.24 | 132.80 | 413.84 | 114.65 | 180.23 | 192.66 | 206.68 | 694.22 |
| Tax rate | -0.9% | -2.1% | -1.1% | -0.2% | -0.7% | -11.4% | 5.1% | -1.7% | -6.4% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Adjusted revenue growth | 72.5% | 63.6% | -1.1% 51.9% | 43.3% | -0.7% 50.6% | -11.4% 60.3% | 67.7% | -1.7% 64.2% | 61.4% | 52.4% | 39.0% | 29.0% | 23.0% | 34.2% | 22.2% | 22.7% | 22.6% | 22.0% | 22.4% |
| Transaction revenue growth | 63.2% | 48.4% | 38.6% | 31.9% | 29.6% | 29.7% | 28.5% | 27.3% | 28.7% | 26.7% | 27.3% | 28.0% | 28.9% | 27.8% | 26.8% | 26.8% | 26.8% | 26.0% | 26.6% |
| Software and data product growth | - | 381.6% | 123.0% | 95.3% | 97.8% | 127.1% | 155.5% | 144.5% | 134.2% | 103.9% | 57.2% | 30.5% | 14.7% | 43.4% | 14.0% | 14.0% | 13.8% | 13.4% | 13.8% |
| Hardware revenue growth | 72.7% | 123.6% | 170.5% | -6.5% | 59.9% | 78.5% | 74.0% | 51.1% | 65.4% | 46.1% | 46.1% | 46.1% | 46.1% | 46.1% | 41.1% | 41.1% | 41.1% | 41.1% | 41.1% |
| EBITDA Margin | -47.7% | -32.5% | -19.3% | -1.7% | -3.5% | 2.5% | 1.4% | 4.2% | 1.5% | -0.5% | 6.9% | 7.7% | 8.0% | 5.8% | 6.1% | 12.4% | 13.3% | 13.7% | 11.6% |
| Adjusted EBITDA margin | -24.5% | -9.1% | 6.7% | 14.1% | 11.7% | 16.9% | 16.5% | 17.5% | 16.0% | 11.0% | 20.6% | 21.4% | 23.3% | 19.4% | 20.1% | 27.4% | 28.3% | 29.7% | 26.6% |

Source: BTIG Estimates and Company Reports



BTIG Covered Companies Mentioned in this Report

SQUARE INC. (SQ, Sell, \$30.00 PT; Current Price: \$79.32; 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

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Distribution of BTIG's Research Recommendations (as of December 31, 2018):

BUY: 59.8%; NEUTRAL: 38.1%; SELL: 2.1%

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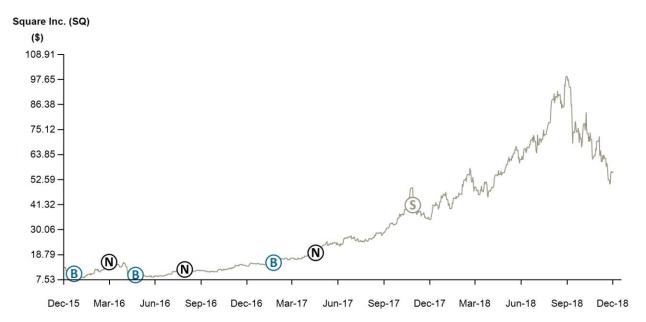
Company Valuation and Risk Disclosures

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

Valuation: Our \$30 price target for SQ is based on 20x our FY20E adjusted EBITDA of \$694mm. 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.





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

| Date | Closing Price (\$) | Target Price (\$) | Analyst | Rating |
|-----------|--------------------|-------------------|-------------|---------|
| 02-Dec-15 | 11.93 | 15 | Mark Palmer | Buy |
| 31-Mar-16 | 15.28 | NA | Mark Palmer | Neutral |
| 23-May-16 | 9.46 | 12 | Mark Palmer | Buy |
| 29-Aug-16 | 12.01 | NA | Mark Palmer | Neutral |
| 22-Feb-17 | 15.04 | 20 | Mark Palmer | Buy |
| 17-May-17 | 19.56 | NA | Mark Palmer | Neutral |
| 27-Nov-17 | 41.02 | 30 | Mark Palmer | Sell |

Other Disclosures

Additional Information Available Upon Request

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