

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

While SQ Tries to "Move the Goalposts" with 2Q19 Report, Payment Volume Growth Deceleration Continues to Pick Up; Reiterating Sell

WHAT YOU SHOULD KNOW: We were not surprised that the 2Q19 report that Square, Inc. (SQ) released today after the market close featured further deceleration of the company's growth in gross payment volume (GPV), a trend that has become evident during the past few quarters, and a decline in its transaction margin. But even less surprising was that SQ management during the company's conference call tried to "move the goalposts" by refocusing investors on growth in absolute dollars of revenue and adjusted EBITDA rather than the metrics that have been used to measure its progress up to this point. Those metrics are telling us that SQ is facing increased competition as it becomes more dependent on larger sellers.

- What we believe to be particularly noteworthy from SQ's 2Q19 report is that the downward pressure on the company's metrics occurred before the company had faced the full impact of the mega-mergers in the payment space particularly Fiserv's (FISV, Not Rated) acquisition of First Data that are likely to provide the company with even tougher sledding in the coming quarters. Increasing competition from alternatives such as FISV's Clover and Clover Go, as well as the proliferating venture-funded, cloud-based "Square point-of-sale clones," is likely to further threaten SQ's GPV growth, and the company's transaction margin is likely to experience additional compression amidst the more challenging pricing dynamic arising from the struggle to capture the business of larger merchants (54% of SQ's 2Q19 GPV, up from 51% in the prior quarter), in our view.
- While SQ during 2Q19 reported a top- and bottom-line beat, the company's GPV growth of 25% was the latest data point in a negative trend. SQ in 3Q18 broke through the psychologically important 30% GPV growth figure to the downside for the first time when the metric came in at 29%. Deceleration continued in 4Q18 with 28% growth in GPV, and the trend continued in 1Q19 as volume grew at 27%. Again, management during the company's conference call said investors should instead focus on absolute dollars of revenue and adjusted EBITDA inasmuch as they better reflect the entirety of its "ecosystem."
- However, we observe that point-of-sale payment processing remains at the core
  of SQ's business, and we believe the claimed uniqueness of the company's
  collection of ancillary product offerings is likely to be put to the test by a slew of
  competitors with similarly attractive offerings.
- We are reiterating our Sell recommendation on SQ and our price target of \$30 based on 20x our FY20E adjusted EBITDA of \$682mm. We view the stock as very expensive at 53.4x FY20E EV/EBITDA.
- Valuation: Our \$30 price target for SQ is based on 20x our FY20E adjusted EBITDA of \$682mm. The multiple we use reflects our anticipation that the company's rapid growth will decelerate.

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## Mark Palmer (212) 588-6582 mpalmer@btig.com

COMPANY DATA	
Closing Price:	\$80.98
Price Target:	\$30.00
Market Cap (\$M):	34,279.24
Shares Out (M):	423.3
Avg Daily Vol - 3 Months (M):	5.96
Dividend/Yield:	\$0.00/0.0%

REVISIONS		
	Previous	Current
Rating	Sell	Sell
Price Target	\$30.00	\$30.00
FY19E EPS	\$0.74	\$0.78
FY20E EPS	\$1.23	\$1.22
FY19E Rev. (M)	\$4,376.81	\$4,610.61

Diluted EPS (Adjusted)											
FY Dec	2018A	2019E	2020E								
Q1	0.06	0.11	0.26								
Q2	0.13	0.21	0.27								
Q3	0.14	0.22	0.33								
Q4	0.10	0.24	0.36								
Calendar EPS	0.43	0.78	1.22								
Calendar P/E	190.4x	104.3x	66.3x								

REVENUE (\$M)												
FY Dec	2018A	2019E	2020E									
Q1	668.60	959.36	1,235.59									
Q2	814.94	1,174.24	1,403.82									
Q3	882.11	1,223.85	1,484.54									
Q4	932.53	1,253.17	1,512.61									
FY	3,298.18	4,610.61	5,636.56									

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



#### **Investment Thesis**

We believe SQ is overvalued and that the company's revenue and gross payment volume (GPV) growth is likely to decelerate as competition for larger merchants becomes more of a headwind. We also view the expansion of Square Capital as making 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 as a negative for the company's risk profile that is not reflected in SQ's lofty multiple.

## **Upcoming Catalysts**

- Potential approval of application for industrial loan company (ILC) charter.
- Closing of payments mega-mergers, including First Data's (FDC, Neutral) with Fiserv (FISV, Not Rated), creating a more challenging competitive environment, particularly for business of larger (>\$125K in annual payment volume) merchants in U.S.

### **Base Case Assumptions**

- Our price target of \$30 for SQ is based on 20x our FY20E adjusted EBITDA of \$682mm.
- As it becomes evident that SQ's current growth rate is unsustainable, the stock's multiple contracts significantly.

## **Upside Scenario**

- SQ's revenue and GPV growth re-accelerate while growth in its non-payment "ecosystem" services surges.
- SQ successfully monetizes the Square CashApp, while its issuance of personal and consumer loans through Square Capital further spurs growth. The stock trades up to \$100.

#### **Downside Scenario**

- SQ's revenue and GPV growth stall in the face of heightened competition for large merchants as competitors offer alternatives that undermine the company's "ecosystem" approach.
- SQ's extension of credit through Square Capital becomes a negative, as reliance on credit to reduce churn becomes a liability during an economic downturn. The stock trades to \$25.

#### Price Performance



Source: IDC

## **Company Description**

Square (NYSE: SQ) provides payment and point-of-sale solutions in the U.S. and internationally. The company's commerce ecosystem includes point-of-sale software and hardware that offers sellers to payment and point-of-sale solutions. The company also offers various software products, including Square Appointments, Square for Retail, Square for Restaurants, Square Invoices, Virtual Terminal, Weebly, and Square Payroll. In addition, it provides Cash App, which enables individuals to electronically send, store, and spend money, and Square Capital, which facilitates loans to sellers based on current payment and point-of-sale data.



- SQ's 2Q19 revenue and earnings beat was unaccompanied by what had been its customary full-year raises. Management reiterated their prior guidance for FY19 adjusted revenue in a range of \$2.25bn to \$2.28bn, adjusted EBITDA in a range of \$405mm to \$415mm, and adjusted EPS in a range of \$0.74 to \$0.78. At the same time, they provided 3Q19 guidance for adjusted EPS in a range of \$0.18 to \$0.20, the higher end of which trailed the consensus estimate of \$0.22. The midpoint of management's 3Q19 revenue guidance range of \$590mm to \$600mm was below the consensus estimate of \$599.5mm.
- SQ disclosed that it was selling Caviar, its food-delivery app, to DoorDash (Private) for \$410mm. Management said Caviar was the second-largest offering in its subscription and services segment as its revenue was less than that generated by Cash App but more than that derived from Square Capital. Management, who disclosed that Caviar had a lower gross margin than the other subscription and services revenue streams, said they would update their guidance after the sale of Caviar closes.
- SQ's subscription and services segment during 2Q19 generated revenue of \$251mm, up 87% year-over-year, while its gross profit of \$191mm was up 102% versus the prior year period. The company disclosed that Cash App during the quarter generated \$135mm in subscription and services-based and transaction-based revenue, and \$125mm in bitcoin revenue. Bitcoin during 2Q19 generated \$2mm of gross profit.
- Square Capital during 2Q19 facilitated approximately 78K loans totaling \$528mm, an increase of 36% versus the prior year period. We continue to believe that while such loans may boost SQ's results in the near term while reducing churn among its core payment customers, growth in lending 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 as a negative for the company's risk profile not reflected in SQ's lofty multiple.
- SQ's 2Q19 transaction margin of 1.06% was down 2bps versus the prior year period. Management said transaction
  margin was "not a metric we use in isolation to measure success," pointing to absolute dollars of revenue and
  metrics such as payback periods ad revenue retention as better performance indicators.



#### **Income Statement**

Square Inc Operating Model	Dec-14	Dec-15	Dec-16	Dec-17	Mar-18	lun-18	Sep-18	Dec-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Dec-21
\$ millions	2014A	2015A	2016A	2017A	1Q18A	2Q18A	3Q18A	4Q18A	2018A	1Q19A	2Q19A	3Q19E	4Q19E	2019E	1Q20E	2Q20E	3Q20E	4Q20E	2020E	1Q21E	2Q21E	3Q21E	4Q21E	2021E
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	656.76	775.51	833.71	855.26	3,121.24	837.13	982.41	1,053.20	1,073.79	3,946.52	1,042.22	1,218.79	1,300.40	1,313.49	4,874.89
Starbucks transaction-based revenue	123.02	1,050.45	78.90	1,920.17	523.04	625.23	655.38	667.80	2,4/1.45	656./6	//5.51	833./1	855.26	3,121.24	837.13	982.41	1,053.20	1,073.79	3,946.52	1,042.22	1,218.79	1,300.40	1,313.49	4,874.89
Subscription and services-based revenue	12.05	58.01	129.35	252.66	97.05	134.33	166.20	194.12	591.71	218.86	251.38	242.52	248.29	961.04	248.42	265.38	275.14	280.45	1,069.38	273.48	292.43	302.74	307.28	1,175.94
Hardware revenue	7.32	16.38	44.31	41.42	14.42	18.36	17.56	18.17	68.50	18.21	22.26	21.29	22.02	83.78	21.17	25.87	24.74	25.60	97.38	23.54	28.78	27.52	28.47	108.31
Bitcoin revenue				-	34.10	37.02	42.96	52.44	166.52	65.53	125.09	126.34	127.60	444.55	128.88	130.16	131.47	132.78	523.28	134.11	135.45	136.80	138.17	544.53
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	959.36	1,174.24	1,223.85	1,253.17	4,610.61	1,235.59	1,403.82	1,484.54	1,512.61	5,636.56	1,473.35	1,675.45	1,767.46	1,787.41	6,703.68
Transaction costs Starbucks transaction costs	450.86 150.96	672.67 165.44	943.20 69.76	1,230.29	327.91	395.35	414.46	420.85	1,558.56	409.07	490.35	525.82	539.30	1,964.54	526.16	617.34	661.69	674.49	2,479.68	654.89	766.51	818.54	827.50	3,067.43
Software and data products cost	2.97	22.47	43.13	75.72	30.37	39.78	47.08	52.65	169.88	60.52	60.12	67.42	68.78	256.84	68.19	72.85	75.53	76.98	293.55	74.39	79.54	82.35	83.58	319.86
Hardware cost	18.33	30.87	68.56	62.39	19.70	25.54	23.23	25.65	94.11	26.94	33.27	24.48	25.33	110.01	23.28	28.46	75.55 27.21	28.16	107.11	74.39 25.90	31.66	30.27	31.32	119.14
Bitcoin costs	10.33	30.87	08.50	02.39	33.87	36.60	42.41	51.95	164.83	64.70	122.94	123.18	124.41	435.22	125.65	126.91	128.18	129.46	510.20	132.77	134.09	135.44	136.79	539.09
Amortization of acquired technology	1.00	5.64	8.03	6.54	1.58	1.86	2.28	1.38	7.09	1.38	1.72	1.80	1.90	6.80	1.99	2.09	2.19	2.30	8.58	2.42	2.54	2.67	2.80	10.43
Total cost of revenue	624.12	897.09	1,132.68	1,374.95	413.43	499.12	529.45	552.47	1,994.48	562.61	708.39	742.70	759.71	2,773.40	745.27	847.65	894.80	911.39	3,399.12	890.36	1,014.34	1,069.25	1,081.98	4,055.94
Gross profit (loss)	226.07	370.03	576.04	839.31	255.17	315.82	352.66	380.05	1,303.70	396.75	465.85	481.15	493.46	1,837.21	490.32	556.17	589.74	601.22	2,237.45	582.99	661.11	698.21	705.43	2,647.74
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Product development	144.64	199.64	268.54	321.89	105.10	114.80	135.77	141.81	497.48	153.56	174.20	168.24	172.84	668.84	176.22	197.68	194.43	198.73	767.07	205.13	230.15	225.52	228.64	889.44
Sales and marketing	112.58	145.62	173.88	253.17	77.27	98.24	116.34	119.31	411.15	133.71	156.42	158.39	159.43	607.95	131.67	181.65	189.54	189.78	692.64	152.84	211.33	219.79	218.25	802.20
General and administrative	94.22	143.47	251.99	250.55	75.50	82.77	85.53	95.45	339.25	101.60	100.51	101.51	104.81	408.43	105.86	106.92	107.99	109.07	429.84	113.43	115.70	116.86	118.02	464.01
Transaction and advance losses	24.08	54.01	51.24	67.02	18.03	21.98	23.60	24.47	88.08	27.84	34.26	35.42	36.34	133.86	35.60	41.80	44.82	45.72	167.94	44.45	52.02	55.56	56.16	208.19
Amortization of acquired customer assets Impairment of intangible assets	1.05	1.76	0.85	0.88	0.27	0.67	1.29	2.13	4.36	2.09	1.29	-	-	3.38	-	-	-	-	-	-	-	-	-	- 1
Total operating expenses	376.57	544,49	746.49	893.51	276.16	318.46	362.53	383.16	1,340.31	418.80	466.69	463.56	473.43	1,822.47	449.36	528.05	536.78	543.29	2,057.48	515.85	609.20	617.71	621.08	2,363.84
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Operating income (loss)	(150.49)	(174.46)	(170.45)	(54.21)	(20.99)	(2.65)	(9.87)	(3.11)	(36.61)	(22.04)	(0.84)	17.59	20.04	14.74	40.96	28.13	52.96	57.92	179.97	67.14	51.91	80.49	84.35	283.90
EBITDA	(131.91)	(146.83)	(132.71)	(16.93)	(10.83)	9.68	5.97	19.53	24.35	(3.07)	17.94	39.35	42.35	96.57	63.06	53.09	79.24	84.73	280.12	93.09	81.22	111.25	115.48	401.04
Adjusted EBITDA	(67.74)	(41.12)	45.74	139.01	35.89	65.32	71.00	81.31	253.52	61.70	105.30	119.15	133.10	419.24	145.57	152.92	184.37	199.13	681.99	189.95	198.43	234.30	248.28	870.96
Interest (income) and expense	1.06	1.16	(0.24)	8.46	2.82	2.66	7.22	5.18	17.87	4.68	5.14	5.19	5.25	20.26	5.30	5.35	5.41	5.46	21.52	5.51	5.57	5.62	5.68	22.39
Other (income) and expense	1.10	0.45	(0.54)	-	-	-	(37.80)	19.44	(18.36)	11.30	1.23	-	-	12.53	-	-	-			-	-	-	-	
Income (loss) before income taxes	(152.65)	(176.07)	(169.67)	(62.66)	(23.81)	(5.30)	20.71	(27.72)	(36.13)	(38.02)	(7.22)	12.40	14.79	(18.05)	35.66	22.78	47.55	52.46	158.45	61.63	46.35	74.87	78.67	261.51
Provision for income taxes	1.44	3.75	1.92	0.15	0.18	0.60	1.07	0.48	2.33	0.13	(0.48)	-	-	(0.35)	-	-	-	-	-	-	-	-	-	-
Net income (loss)	(154.09)	(179.82)	(171.59)	(62.81)	(23.99)	(5.91)	19.64	(28.20)	(38.45)	(38.15)	(6.74)	12.40	14.79	(17.70)	35.66	22.78	47.55	52.46	158.45	61.63	46.35	74.87	78.67	261.51
Adjusted EPS - Diluted		(0.39)	0.04	0.27	0.06	0.13	0.14	0.10	0.43	0.11	0.21	0.22	0.24	0.78	0.26	0.27	0.33	0.36	1.22	0.34	0.35	0.41	0.43	1.53
Characteristics diluted		170.50	362.58	426.52	461.76	470.02	474.92	488.18	478.90	487.06	486.53	491.40	496.31	490.32	500.03	502.53	505.05	507.57	503.80	511.38	513.94	516.51	519.09	515.23
Shares outstanding - diluted		170.50	362.58	426.52	461./6	470.02	474.92	488.18	478.90	487.06	486.53	491.40	496.31	490.32	500.03	502.53	505.05	507.57	503.80	511.38	513.94	516.51	519.09	515.23
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	959.36	1,174.24	1,223.85	1,253.17	4,610.61	1,235.59	1,403.82	1,484.54	1,512.61	5,636.56	1,473.35	1,675.45	1,767.46	1,787.41	6,703.68
Starbucks transaction revenue	123.02	142.28	78.90	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-		'	· . '	-	-
Transaction costs	450.86	672.67	943.20	1,230.29	327.91	395.35	414.46	420.85	1,558.56	409.07	490.35	525.82	539.30	1,964.54	526.16	617.34	661.69	674.49	2,479.68	654.89	766.51	818.54	827.50	3,067.43
Bitcoin costs	- 1	- 1	- 1		33.87	36.60	42.41	51.95	164.83	64.70	122.94	123.18	124.41	435.22	125.65	126.91	128.18	129.46	510.20	132.77	134.09	135.44	136.79	539.09
Deferred revenue adjustment	-		686.62		-	2.44	5.89	4.52	12.85	3.46	1.85	5.46	5.59	16.35	5.59	5.97	6.19	6.31	24.06	6.15	6.58	6.81	6.91	26.46
Adjusted revenue	276.31	452.17	686.62	983.96	306.82	385.43	431.14	464.25	1,587.64	489.05	562.80	580.31	595.04	2,227.20	589.37	665.54	700.87	714.97	2,670.75	691.85	781.43	820.30	830.04	3,123.62
Net income (loss)	(154.09)	(179.82)	(171.59)	(62.81)	(23.99)	(5.91)	19.64	(28.20)	(38.45)	(38.15)	(6.74)	12.40	14.79	(17.70)	35.66	22.78	47.55	52.46	158.45	61.63	46.35	74.87	78.67	261.51
Starbucks transaction revenue	(123.02)	(142.28)	(78.90)	- 1	- '	- '	-	- '	- 1	- '	- '	-	-	- '	-	-	-	-	-	-	-	-	-	-
Starbucks transaction costs	150.96	165.44	69.76	- 1	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Share-based compensation expense	36.12	82.29	138.79	155.84	46.82	52.12	58.91	59.03	216.88	61.09	79.47	79.79	90.74	311.09	82.51	99.83	105.13	114.40	401.87	96.86	117.21	123.04	132.81	469.93
Depreciation and amortization	18.59	27.63	37.75	37.28	10.16	12.33	15.84	22.64	60.96	18.97	18.78	21.76	22.31	81.83	22.10	24.96	26.28	26.81	100.15	25.94	29.30	30.76	31.13	117.14
Interest (income) expense	1.06	1.16	(0.24)	8.46	2.82	2.66	7.22	5.18	17.87	4.68	5.14	5.19	5.25	20.26	5.30	5.35	5.41	5.46	21.52	5.51	5.57	5.62	5.68	22.39
Other (income) expense	1.10	0.45	48.32	-		3.45	(37.80)	19.44	(14.91)	11.30	1.23	-	-	12.53	-	-	-	-	-	-	-	-	-	-
Provision (benefit) for income taxes	1.44	3.75	1.92	0.15	0.18	0.60	1.07	0.48	2.33	0.13	(0.48)	-	-	(0.35)	-	-	-	-	-	-	-	-	-	-
Loss on sale of property plant and equipment	0.11	0.27	(0.05)	0.10	(0.10)	0.07	0.81 5.31	2.76	0.78 8.07	0.02 3.66	0.28 7.62	-	-	0.30 11.28	-	-	-	-	-	-	-	-	-	- 1
Adjusted EBITDA	(67.74)	(41.12)	45.74	139.01	35.89	65.32	71.00	81.31	253.52	61.70	105.30	119.15	133.10	419.24	145.57	152.92	184.37	199.13	681.99	189.95	198.43	234.30	248.28	870.96
Tax rate	-0.9% 72.5%	-2.1% 63.6%	-1.1% 51.9%	-0.2% 43.3%	-0.7% 50.6%	-11.4% 60.3%	5.1% 67.7%	-1.7% 64.2%	-6.4% 61.4%	-0.3% 59.4%	6.6%	0.0% 34.6%	0.0% 28.2%	1.9%	0.0% 20.5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0% 17.4%	0.0%	0.0%	0.0%
Adjusted revenue growth Transaction revenue arowth	72.5% 63.2%	48.4%	51.9% 38.6%	43.3% 31.9%	29.6%	60.3% 29.7%	67.7% 28.5%	64.2% 27.3%	61.4% 28.7%	59.4% 25.6%	46.0% 24.0%	34.6% 27.2%	28.2% 28.1%	40.3% 26.3%	27.5%	18.3% 26.7%	20.8% 26.3%	20.2% 25.6%	19.9% 26.4%	17.4% 24.5%	17.4% 24.1%	23.5%	16.1% 22.3%	23.5%
Software and data product growth	03.270	48.4% 381.6%	123.0%	95.3%	97.8%	29.7% 127.1%	28.5% 155.5%	144.5%	134.2%	125.5%	24.0% 87.1%	27.2% 45.9%	28.1%	62.4%	13.5%	5.6%	13.5%	13.0%	11.3%	10.1%	10.2%	10.0%	9.6%	10.0%
Hardware revenue arowth	72.7%	123.6%	170.5%	-6.5%	59.9%	78.5%	74.0%	51.1%	65.4%	26.3%	21.2%	21.2%	21.2%	22.3%	16.2%	16.2%	16.2%	16.2%	16.2%	11.2%	11.2%	11.2%	11.2%	11.2%
EBITDA Margin	-47.7%	-32.5%	-19.3%	-1.7%	-3.5%	2.5%	1.4%	4.2%	1.5%	-0.6%	3.2%	6.8%	7.1%	4.3%	10.7%	8.0%	11.3%	11.9%	10.5%	13.5%	10.4%	13.6%	13.9%	12.8%
Adjusted EBITDA margin	-24.5%	-9.1%	6.7%	14.1%	11.7%	16.9%	16.5%	17.5%	16.0%	12.6%	18.7%	20.5%	22.4%	18.8%	24.7%	23.0%	26.3%	27.9%	25.5%	27.5%	25.4%	28.6%	29.9%	27.9%

Source: BTIG Estimates and Company Reports



## BTIG Covered Companies Mentioned in this Report

SQUARE INC. (SQ, Sell, \$30.00 PT; Current Price: \$80.98; 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.

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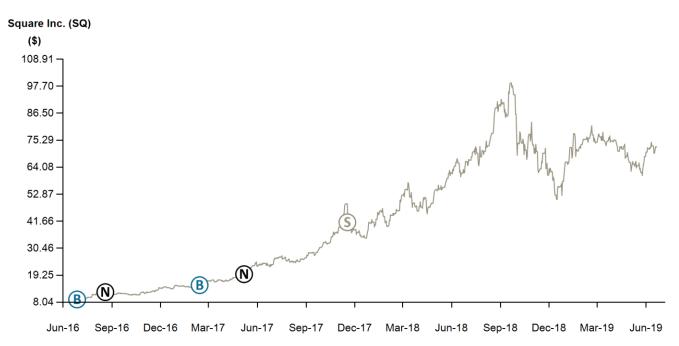
## **Company Valuation and Risk Disclosures**

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

**Valuation:** Our \$30 price target for SQ is based on 20x our FY20E adjusted EBITDA of \$682mm. 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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