

Equity Research

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Financials

Square Inc.

Growth and Profitability Shine Through in 4Q16 Report; Upgrading to Buy (from Neutral) with \$20 PT

We are upgrading Square Inc. (SQ) to Buy (from Neutral) with a \$20 price target based on 24x our FY20E adjusted EBITDA of \$470mm discounted back at 10%. While we had been impressed by SQ's answers to questions about its ability to post profitable growth during the past couple of quarters, the company found another gear during 4Q16. Given this confirmation of an upturn in the trajectory of SQ's profitable growth, we believe a fuller valuation is merited.

- SQ during the quarter posted emphatic outperformance in each of the categories that matter to investors, starting with \$30mm in adjusted EBITDA, up 150% sequentially and well ahead of the consensus estimate of \$18mm and our estimate of \$16mm. The company's adjusted EBITDA margin of 16% represented an improvement of 20 points versus the prior year period as it benefitted from operating leverage as well as growth in its higher-margin services.
- SQ's beat was paced by 4Q16 adjusted revenue of \$192mm, representing year-over-year growth of 43%, which outpaced the consensus estimate of \$188mm and our estimate of \$187mm. SQ also posted gross payment volume (GPV) of \$13.7bn, up 34% versus the prior year period and just ahead of the consensus estimate of \$13.65bn.
- We have noted the importance of SQ's Software and Data Products segment to the sustained growth of the company's profitability, as businesses such as Square Capital, Caviar and Instant Deposit feature higher margins and their revenues are more recurring in nature than those of its core payments business. The segment, which has been relabeled "subscription and services-based revenue," continued its solid growth in 4Q16 in generating \$41mm in revenue, up 17% sequentially and 81% year-over-year.
- Valuation:** Our \$20 price target is based on 24x our FY20E adjusted EBITDA of \$470mm discounted back at 10%. The multiple we employ reflects SQ's strong growth prospects and the operating leverage inherent in its business model.

SQ

\$15.04

12 month target

\$20.00

BUY

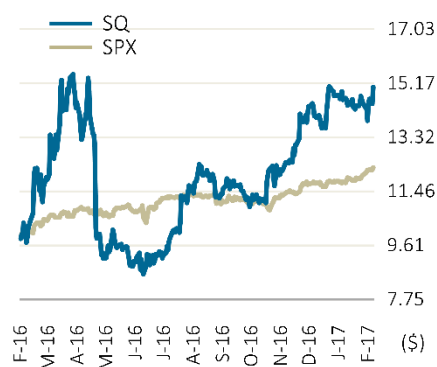
52 week range

\$8.62 - \$15.48

Market Cap (m)

\$5,753

Price Performance



Source: IDC

Estimates

	1Q16 A	2Q16 A	3Q16 A	4Q16 A	FY16 A	1Q17 E	2Q17 E	3Q17 E	4Q17 E	FY17 E	FY18 E
Sales	379	439	439	452	1,709	454	537	555	575	2,121	2,662
EBITDA (Adj.)	(8)	13	12	30	46	18	30	33	35	115	216

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

- ▶ Square Capital during 4Q16 facilitated \$248mm in business loans, up 19% sequentially and 68% versus the prior year period, while loan default rates remained near the expected level of 4%. Meanwhile, SQ processed \$624mm in GPV from its Invoices offering, up 68% year-over-year.
- ▶ Square Capital, as well as Caviar, Instant Deposit, Invoices, APIs and other products launched since 2014 represented 25% of SQ's adjusted revenue in 4Q16. As a reminder, the company is able to cross-sell such products at little or no marketing expense given its installed base of more than 2mm sellers.
- ▶ SQ offered guidance for 1Q17 adjusted revenue in a range of \$190mm to \$193mm and for 1Q17 adjusted EBITDA in a range of \$14mm to \$18mm. While the revenue guidance was wrapped around the consensus estimate of \$191.2mm, the low end of the adjusted EBITDA guidance was higher than the consensus estimate of \$12.5mm
- ▶ SQ also guided to FY17 adjusted revenue in a range of \$880mm to \$900mm and for FY17 adjusted EBITDA in a range of \$100mm to \$110mm. The low end of the FY17 adjusted EBITDA guidance was well above the consensus estimate of \$82mm while wrapped around our estimate of \$103mm.

Income Statement

Square Inc. - Operating Model	Dec-12	Dec-13	Dec-14	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Dec-17	Dec-18	Dec-19	Dec-20
\$ millions	2012A	2013A	2014A	2015A	1Q16A	2Q16A	3Q16A	4Q16A	2016A	1Q17E	2Q17E	3Q17E	4Q17E	2017E	2018E	2019E	2020E
Transaction-based revenue	193.98	433.74	707.80	1,050.45	300.45	364.86	388.35	402.50	1,456.16	399.45	477.57	494.64	507.44	1,879.11	2,359.21	2,917.37	3,545.43
Starbucks transaction-based revenue	9.47	114.46	123.02	142.28	38.84	32.87	7.16	0.03	78.90	-	-	-	-	-	-	-	-
Subscription and services-based revenue	-	-	12.05	58.01	23.80	29.72	35.32	40.52	129.35	41.98	47.23	50.25	55.96	195.43	247.54	302.35	371.02
Hardware revenue	-	4.24	7.32	16.38	16.18	11.09	8.17	8.87	44.31	12.14	12.19	9.81	11.97	46.11	55.33	63.63	69.99
Total net revenue	203.45	552.43	850.19	1,267.12	379.27	438.53	439.00	451.92	1,708.72	453.58	537.00	554.70	575.37	2,120.65	2,662.08	3,283.35	3,986.45
Transaction costs	126.35	277.83	450.86	672.67	194.28	234.86	254.06	260.01	943.20	261.71	312.89	324.08	332.46	1,231.14	1,551.04	1,929.72	2,359.50
Starbucks transaction costs	12.55	139.80	150.96	165.44	36.61	28.67	4.53	(0.05)	69.76	-	-	-	-	-	-	-	-
Software and data products cost	-	-	2.97	22.47	9.03	10.14	12.52	11.43	43.13	11.21	12.62	13.42	14.95	52.20	62.41	71.69	84.27
Hardware cost	-	6.01	18.33	30.87	26.74	14.02	15.69	12.12	68.56	14.32	14.39	11.57	14.13	54.41	64.04	73.17	76.99
Amortization of acquired technology	-	-	1.00	5.64	2.37	1.89	1.89	1.89	8.03	1.98	2.08	2.18	2.29	8.54	10.37	12.61	15.33
Total cost of revenue	138.90	423.65	624.12	897.09	269.03	289.57	288.69	285.39	1,132.68	289.23	341.98	351.25	363.83	1,346.29	1,687.86	2,087.20	2,536.09
Gross profit (loss)	64.55	128.79	226.07	370.03	110.24	148.96	150.31	166.53	576.04	164.35	195.02	203.45	211.54	774.36	974.22	1,196.15	1,450.36
Product development	46.57	82.86	144.64	199.64	64.59	68.64	70.42	64.89	268.54	70.30	83.18	85.87	89.01	328.36	391.44	457.18	523.99
Sales and marketing	56.65	64.16	112.58	145.62	38.50	39.22	46.75	49.41	173.88	51.03	60.41	62.40	64.73	238.57	285.75	335.04	395.62
General and administrative	36.18	68.94	94.22	143.47	96.11	50.78	52.08	53.03	251.99	53.56	54.09	54.63	55.18	217.46	223.49	228.00	232.59
Transaction and advance losses	10.51	15.33	24.08	54.01	7.86	17.46	12.89	13.03	51.24	13.10	15.67	16.23	16.65	61.65	69.50	86.24	105.18
Amortization of acquired customer assets	-	-	1.05	1.76	0.32	0.22	0.16	0.15	0.85	-	-	-	-	-	-	-	-
Impairment of intangible assets	-	2.43	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total operating expenses	149.91	233.73	376.57	544.49	207.37	176.32	182.30	180.50	746.49	187.99	213.35	219.13	225.57	846.05	970.18	1,106.46	1,257.38
Operating income (loss)	(85.36)	(104.94)	(150.49)	(174.46)	(97.13)	(27.36)	(31.98)	(13.98)	(170.45)	(23.65)	(18.33)	(15.68)	(14.02)	(71.68)	4.04	89.70	192.98
Adjusted EBITDA	(70.58)	(51.53)	(67.74)	(41.12)	(8.23)	12.55	11.62	29.79	45.74	18.08	29.72	32.57	34.59	114.95	215.63	334.26	469.98
Interest (income) and expense	0.01	(0.01)	1.06	1.16	0.07	(0.13)	(0.18)	-	(0.24)	-	-	-	-	-	-	-	-
Other (income) and expense	(0.17)	(0.95)	1.10	0.45	(0.79)	(0.20)	0.29	0.15	(0.54)	-	-	-	-	-	-	-	-
Income (loss) before income taxes	(85.20)	(103.98)	(152.65)	(176.07)	(96.42)	(27.03)	(32.09)	(14.13)	(169.67)	(23.65)	(18.33)	(15.68)	(14.02)	(71.68)	4.04	89.70	192.98
Provision for income taxes	-	0.51	1.44	3.75	0.34	0.31	0.23	1.04	1.92	-	-	-	-	-	-	-	-
Net income (loss)	(85.20)	(104.49)	(154.09)	(179.82)	(96.76)	(27.35)	(32.32)	(15.17)	(171.59)	(23.65)	(18.33)	(15.68)	(14.02)	(71.68)	4.04	89.70	192.98
Adjusted EPS - Diluted				(0.39)	(0.05)	0.02	0.01	0.05	0.04	0.03	0.05	0.06	0.06	0.20	0.41	0.65	0.91
Shares outstanding - diluted				170.50	331.32	365.73	370.75	382.53	362.58	386.36	390.22	394.12	398.06	392.19	406.15	418.33	431.02
Total net revenue	203.45	552.43	850.19	1,267.12	379.27	438.53	439.00	451.92	1,708.72	453.58	537.00	554.70	575.37	2,120.65	2,662.08	3,283.35	3,986.45
Starbucks transaction revenue	9.47	114.46	123.02	142.28	38.84	32.87	7.16	0.03	78.90	-	-	-	-	-	-	-	-
Transaction costs	126.35	277.83	450.86	672.67	194.28	234.86	254.06	260.01	943.20	261.71	312.89	324.08	332.46	1,231.14	1,551.04	1,929.72	2,359.50
Adjusted revenue	67.63	160.14	276.31	452.17	146.16	170.81	177.78	191.88	686.62	191.86	224.11	230.63	242.91	889.51	1,111.04	1,353.63	1,626.94
Net income (loss)	(85.20)	(104.49)	(154.09)	(179.82)	(96.76)	(27.35)	(32.32)	(15.17)	(171.59)	(23.65)	(18.33)	(15.68)	(14.02)	(71.68)	4.04	89.70	192.98
Starbucks transaction revenue	(9.47)	(114.46)	(123.02)	(142.28)	(38.84)	(32.87)	(7.16)	(0.03)	(78.90)	-	-	-	-	-	-	-	-
Starbucks transaction costs	12.55	139.80	150.96	165.44	36.61	28.67	4.53	(0.05)	69.76	-	-	-	-	-	-	-	-
Share-based compensation expense	8.11	14.66	36.12	82.29	31.20	36.92	36.78	33.89	138.79	31.74	36.24	36.05	35.95	139.98	153.03	172.33	189.30
Depreciation and amortization	3.58	8.27	18.59	27.63	9.12	9.02	9.68	9.93	37.75	9.98	11.81	12.20	12.66	46.65	58.57	72.23	87.70
Interest (income) expense	0.01	(0.01)	1.06	1.16	0.07	(0.13)	(0.18)	-	(0.24)	-	-	-	-	-	-	-	-
Other (income) expense	(0.17)	(0.95)	1.10	0.45	50.07	(2.20)	0.29	0.15	48.32	-	-	-	-	-	-	-	-
Provision (benefit) for income taxes	-	0.51	1.44	3.75	0.34	0.31	0.23	1.04	1.92	-	-	-	-	-	-	-	-
Loss on sale of property plant and equipment	0.01	2.71	0.11	0.27	(0.04)	0.17	(0.22)	0.04	(0.05)	-	-	-	-	-	-	-	-
Impairment of intangible assets	-	2.43	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Adjusted EBITDA	(70.58)	(51.53)	(67.74)	(41.12)	(8.23)	12.55	11.62	29.79	45.74	18.08	29.72	32.57	34.59	114.95	215.63	334.26	469.98
Tax rate	-	-0.5%	-0.9%	-2.1%	-0.4%	-1.2%	-0.7%	-7.3%	-1.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Adjusted revenue growth	-	136.8%	72.5%	63.6%	63.8%	54.5%	50.9%	42.6%	51.9%	31.3%	31.2%	29.7%	26.6%	29.5%	24.9%	21.8%	20.2%
Transaction revenue growth	-	123.6%	62.2%	48.4%	42.3%	40.4%	38.2%	34.8%	38.6%	33.0%	30.9%	27.4%	26.1%	29.0%	25.5%	23.7%	21.5%
Software and data product growth	-	-	-	381.6%	197.2%	129.9%	140.4%	81.0%	123.0%	76.4%	58.9%	42.3%	38.1%	51.1%	26.7%	22.1%	22.7%
Hardware revenue growth	-	-	72.7%	123.6%	634.2%	208.7%	94.2%	39.1%	170.5%	-25.0%	10.0%	20.0%	35.0%	4.1%	20.0%	15.0%	10.0%
Adjusted EBITDA growth	-	-27.0%	31.5%	-39.3%	-59.1%	1361.5%	-173.7%	-590.9%	-211.3%	-319.7%	136.8%	180.2%	16.1%	151.3%	87.6%	55.0%	40.6%
Adjusted EBITDA margin	-104.4%	-32.2%	-24.5%	-9.1%	-5.6%	7.3%	6.5%	15.5%	6.7%	9.4%	13.3%	14.1%	14.2%	12.9%	19.4%	24.7%	28.9%

Source: BTIG Estimates and Company Reports

BTIG Covered Companies Mentioned in this Report

SQUARE INC. (SQ, Buy, \$20.00 PT; Current Price: \$15.04; Analyst: Mark.Palmer)

Appendix: Analyst Certification and Other Important Disclosures

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Company Valuation and Risk Disclosures

Square Inc. (SQ, Buy, \$20.00 PT)

Valuation: Our \$20 price target is based on 24X our 2020E EBITDA estimate of \$470mm discounted back at 10%. Our multiple reflects our anticipation of the company's continued rapid growth, while our 10% discount rate reflects our estimate of the company's cost of capital.

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.

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	N/A	Mark Palmer	Neutral
23-May-16	10.14	12	Mark Palmer	Buy
29-Aug-16	12.07	N/A	Mark Palmer	Neutral

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Additional Information Available Upon Request

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