Continued Industry Tailwinds Should Support Square's Story

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Summary

- We see SQ as a solid story with multiple industry tailwinds, such as EMV and continued cash-to-plastic conversion.
- Convenient processing and analytics remains key to Square's popularity.
- Our valuation supports at least 25% upside from the current levels.

Basic Business / Product Analysis:

Square, Inc. is a financial services company that focuses on software and hardware payments products. Square Register allows merchants to accept offline debit and credit cards on both smart-phones and tablet computers. Merchants enter card details through the Square Reader, which plugs into the supported smart-phone/tablet and reads the magnetic stripe.

We see Square as uniquely positioned to take advantage of several major developments in the evolution of point-of-sale (POS) transactions and, indeed, the payments world as a whole over the last decade. The company stands at the forefront of payment processing, adopting and integrating recent trends. At the same time, Square’s products cater to a
wide variety of merchants, from retail stores to restaurants to cabs, particularly smaller businesses – those that are often overlooked by Square’s established competitors in the terminals space, such as VeriFone and Ingenico.

Valuation:

When we compare Square against its peers in the payments industry, such as VeriFone and Ingenico, as well as other players, such as GPN, ADS, V, and MA, among others, we find that the company merits a revenue multiple of 6.3x on 2020 revenue, which would result in the target price of $74.

Target Price Justification / Near-Term Catalysts:

1. **Strong Total Addressable Market**: For Square, both the growth of card products and the penetration of mobile solutions signal the rising demand for innovative terminalization, as existing and new merchants increasingly require not only new hardware (both EMV and NFC-enabled), but also software to 1) accept payments; 2) process business analytics; and 3) streamline operations. The Square Register app combines with Square’s hardware to enable mobile device as a POS terminal, making the transaction process quicker and simpler for buyers and merchants. The Square Analytics and Invoices meaningfully facilitate the back-end for merchants, alleviating operational burdens, such as refunds and charge-backs, which traditional terminal manufacturers do not address.

2. **EMV Opportunities**: With only 55% of retailers in EMV compliance (an average figure that we believe is largely skewed toward larger retailers, who are ~80-90% compliant, while micro/small merchant adoption is as low as 40-50%), Square faces a significant opportunity to market its own products. A disruptor in the space, it now operates in a rapidly changing POS environment, when the EMV adoption slows down the customer at the POS, complicates processing for the merchant, and thus raises incentives to switch to an alternative product, such as Square’s. We note that the Square Reader product can be both EMV and NFC-enabled.

3. **Attractive Pricing**: Square charges merchants a payment processing fee of 2.75% on gross purchase volume (GPV), which is meaningfully below the merchant discount rate (MDR) of 3-4% that merchants frequently pay on non-Square transactions. In addition, the company charges a 3.5% fee and $0.15 per transaction fee for manually entered card-not-present transactions (where the incidence of fraud may be substantially greater). We note
that about 70% of transactions are card-present and approximately 30% are CNP. We view this pricing structure, particularly for card-present transactions, as key to Square’s value proposition, since a lot of merchants have reservations about the rising MDR, especially for more expensive American Express transactions, as well as about the overall complexity of charges, since in addition to the MDR they often face incremental processing costs, such as batch fees and charge-backs.

4. **International Expansion is Key!** We believe that Western Europe, Australia/New Zealand, and possibly Brazil, are the next geographic candidates for Square’s expansion. All these countries/regions saw rapid growth in smart-phones over the recent years. In addition, the number of POS terminals in the European Union is roughly equivalent to that in the United States, with about 10-11 MM terminals in both regions as of 2018. If we look at the POS terminal shipment data, for the year 2012 the United States was actually lagging many other key regions: out of a total ~20 MM terminals shipped during that year – the United States accounted for only 1.9 MM terminals, which in itself signals the vastness of the non-US opportunity for Square.

5. **Convenient Processing / Analytics:** Square’s payments and POS services channel both hardware and software to enable payments acceptance. The Square Register product (a POS application) links into the mobile device, such as iPhone or iPad, to process the transaction. Square Analytics and Invoices allow merchants to study the back end and manage daily operations. Square acts as a merchant of record for sellers, handling complex systems and rules, and assuming the risk of charge-backs and refunds.

6. **Paradigm Shift in Payments:** Over the past decade there has been solid transition from cash and checks to card products in the United States, with 1-1.5% percentage points of the entire purchase volume shifting from cash to cards annually. At present, there is approximately 55-60% of consumer payments volume processed on credit, debit, or prepaid cards, while about 25-30% of volume is still done via cash, checks, and money orders (“paper” transactions). According to a Nilson report, by 2022 there may be as much as two thirds of US consumer volume processed via card payments.

**Risks to Our Thesis:**

We see the following risks to our thesis.

1. **Competitive Pressures:**
Square’s success could lead to entrance of new players, who would eat away a portion of the company’s market share

2. Pricing Wars:

We believe that SQ may more pricing headwinds from VeriFone and, to a lesser extent, Ingenico. Square already offers one of the lowest-priced products in this space; however, other companies are aggressively catching up.

3. Economic Slowdown:

As economy gradually softens in the United States, Europe, and China, we may see fewer lower payments volume, but, even more importantly, we may see fewer new merchants joining Square’s platform.

4. Rise of Alternative Payment Solutions:

With the payments space rapidly developing, we believe that a rise of various alternative solutions, particularly on the mobile side, possesses a significant threat to Square. Merchants are increasingly looking for an opportunity to save on the discount rate, which should foster more research in that direction and thus pose a meaningful threat to Square.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

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Square is an amazing story, they started by just being the card processor in small local markets and trade shows, now they are all over and expanding globally, but the parts time CEO seems to gotten tired and lost steam, the CFO is not showing much either, I like this company but changes need to be done to unlock the maximum potential.

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