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Can Afterpay's magic run continue?

by Jonathan Shapiro

As Elon Musk and Tesla have shown us, when dizzy valuations and high short interest collide, the results can be spectacular. If the Australian stock market has a battleground stock to rival Tesla it is the buy now, pay later juggernaut Afterpay, which has doubled to a market capitalisation of over $3 billion in just six weeks.

In that time, the shorts have been decimated as Afterpay successfully kicked off its US adventure.

As it stands, Afterpay which closed on Friday at $14.57 is now valued at 100 times forward earnings and at 50 times based on fiscal 2020 earnings forecasts.

So is the run done?

Not even close, if you ask the bulls.

One chuffed investor went as far as to suggest Afterpay's shares could be worth up to $50 if you make some rather heroic comparisons to Amazon.

The sell-side broker community was only marginally less buoyant. And it's hard to blame them given how well their calls have played out.

Bell Potter, which championed the stock, lifted its price target to $21 following Afterpay's July update calling it a "next generation PayPal" which it said was attracting the attention of Visa and Mastercard.

By focusing on its price to earnings ratio, Bell Potter said investors risked "the story and the opportunity". The share price could double even if earnings are flat as it gains revenue and market share. Afterpay, it says, is whipping PayPal in terms of converting online customers to in-store.

But therein lies the wide philosophical divide among Afterpay's bulls and bears.

The bulls believe Afterpay should be valued as a payments platform company, with all the wonderful economics of scale that come with clipping a ticket on an expanding volume of transactions.

The bears see that as folly. To them Afterpay is consumer finance company that needs more capital and funding as it grows, and has to manage its credit risk, and risk more generally.

There's even a divide as to who is using Afterpay. The bulls are of the view that Afterpay customers as contentious credit averse spenders that use the platform to manage their budgets.

The bears suspect a high enough proportion may be customers that could not, or should not, get a loan of any sort.

While there are some regulatory developments afoot, Afterpay is not legally defined as a credit provider.

It charges margins to retailers, like a payments company, and charges only late fees, not interest, if instalment payments are missed by customers.

But in trying to value the company and understand its economics there must surely be merit in analysing the company as a lender.

High profile investor Roger Montgomery recently had a go, describing the 2.5 per cent net transaction margin Afterpay generated in 2017 as "not particularly earth-shattering".

Afterpay's net transaction margin is hardly the focus of the market, which is salivating at the prospect of breaking into the US.

But in time, the performance of its book could attract more attention, particularly if that oft warned-about turn in the credit cycle ever eventuates.

For now Afterpay's loan loss disclosures paint a positive and improving picture. This supports the view that since Aftepay's loans are relatively small, short-term and aimed at budget-conscious shoppers its bad debt experience is better than its rivals.

But getting a true sense of the performance of Afterpay's book is tricky. The bears suspect that Afterpay's rapid growth masks the true extent of its credit performance for any one period.

The company uses its own metric to assess credit performance – the net transaction loss – which nets off the late fees charged to customers against its bad debts. That is around 0.7 per cent of transactions.

The rationale behind this bespoke measure is that since Afterpay's loan book turns over so rapidly (the same dollar is advanced and returned three to four months in a quarter) a static measure of bad debts can't keep pace.

Naturally the few remaining bears aren't convinced, particularly around the use of late payments which will be capped in the coming financial year.

Some credit experts say the best guide of its bad debt experience is in the trade receivables tables that are disclosed once a year in the annual report.

Some have attempted to come up with a more static measure of bad debts by assuming the reported 60-plus day arrears number is a proxy for write-offs, and then backsolving the transaction volume for that month based on assumed growth rates. This method does suggest loan losses in the 2017 financial year could have been higher than reported.

But the bulls, including Goldman analyst Ashwini Chandra, say that if Afterpay's debt ratios were indeed misleading it would have raised more equity than it has at this stage.

One recent development worth keeping an eye on is comments by debt collector Credit Corp that 40 per cent of their Wallet Wizard personal loan product customers have a "buy now pay later" payment in their transaction history.

This is unlikely to account for a meaningful portion of Afterpay customers but may be instructive in the future.

For now though, the market is emphatically siding with the bulls in valuing Afterpay as a real global payments challenger. And if their loan quality remains as good as it appears, the bears will have to admit that they are exactly that.