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Buy now, pay later: that's for sure

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Just recently Tesla split its stock five-for-one and then rallied 12 per cent on the day the split shares recommenced trading. After this happened, I thought the market had reached a new and unsustainable level of nutty. But I was wrong.

Shortly after Tesla's split, San Mateo, California-based data warehousing specialist Snowflake listed.

Last year most of the companies that IPO'd were relatively mature by the standards of Wall Street. Uber's massive listing was after it had raised tens of billions in private markets, and six years after it first achieved unicorn status in 2013.

By contrast Snowflake entered 2020 having raised $US920m ($1.3bn) and was "valued" at $US4bn. Then, more strikingly, in February this year, it raised $US478.8m at a $US12.4bn valuation. Shortly after, during the northern hemisphere summer, the company filed for an IPO. Private equity players were said to be optimistic about a $US20bn valuation.

Snowflake, a data company, is profitless. It generated revenue in FY20 (its year-end is January) of $US265m and lost it all as well as another $US349m.

Stories such as the Snowflake IPO have prompted many investors to variously describe the current market as a joke, a bubble, a Ponzi scheme, a casino and a lottery.

Australia has its own brand of nutty: Afterpay.

I sometimes wonder how we will look back on the hitherto irrepressible rise of profitless growth stocks. Trading well above normal historic multiples, their very strong performance is tough to rationalise with fundamentals. Their booming prices seem to be the product of a speculative bubble. And buy now, pay later (BNPL) providers in particular, such as Afterpay and Klarna, are by no small measure recipients of the broader irrational ebullience.

When BNPL operator Afterpay's closing share price peaked at $92.48 in late August this year, its market capitalisation was $26.3bn. This was remarkable for a number of reasons. Its market value had risen 2500 per cent in three years and eightfold since March. At that moment, Afterpay was then worth more than Cochlear and Sydney Airports combined, worth more than double Scentre — the operator of Australia's Westfield malls — and worth 25 per cent more than Coles.

For a company generating revenue of just $230m (compared to Coles' $37.4bn) and losing money, a $26.3bn market capitalisation was an extraordinary achievement, and with today's market capitalisation of $22bn it remains Australia's 16th largest listed company with a share price near $78.

But Afterpay isn't alone. The BNPL model is also offered by US-based Sezzle, Klarna and Zebit, Israeli firm Splitit, New Zealand's Laybuy, Affirm, Payright, and a host of other operators including FlexiGroup's Humm and Bundll, and PayPal's "Pay in 4". Indeed, payment giants, Visa and MasterCard (Quadpay) have also revealed products that can only be described as BNPL.

Afterpay's product, which allows consumers to purchase products with an interest-free, unsecured loan, is one source of their advantage over credit card providers. The other is the contractual "no surcharge" agreement retailers enter with the likes of Afterpay that prevents the merchant passing on the additional cost to the consumer. Afterpay gains an advantage because it can market its offering as free to all customers who pay on time.

Importantly, the credit and debit card charges that merchants do pass on amount to 0.5-1.5 per cent. BNPL charges can be as high as 7 per cent, according to UBS.

If retailers continue to allow this asymmetric approach, they will strengthen Afterpay's market power at the expense of credit card providers and ultimately give Afterpay and its ilk the ability to charge them even more.

For regulators and consumer-interest groups, the significant charges will ultimately result in higher retail prices for all consumers. And with BNPL offers most attractive to younger consumers without the money to pay for a product upfront, pure-play BNPL providers that only require superficial information might suffer most from regulatory scrutiny.

According to Roy Morgan, more than half of BNPL users are consumers under the age of 35. But regulators also need to be mindful that wiping out BNPL could dent retail sales and adversely impact the discretionary consumer sector.

Nevertheless, the rising competition globally and the regulatory tightrope being walked by BNPL providers, combined with stretched market valuations, suggests investors need to tread carefully. It's worth remembering that during the COVID-19 inspired sell-off Afterpay's shares fell 77.5 per cent.

The threats of increasing competition, rising regulatory risk and stretched valuations may be the reason Afterpay's CFO has just announced his resignation, and it is certainly the reason we see very wide valuation and price-target dispersion among sell-side analysts. UBS reckons Afterpay's shares are worth less than $30 while Morgan Stanley has had a price target of over $100.00.

And while there is no shortage of BNPL pure-plays, those that are publicly traded are all listed in Australia. One might argue that the multiples considered normal by Australian investors are a joke to investors elsewhere. If they're right, it may be worth ensuring you can look back on this moment in stockmarket history and laugh.

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