Square

Investor Update Confirms SMB Pressure, But SQ Can Weather the Storm; Cutting Est, PT; Stay OW

Overweight

SQ, SQ US
Price (24 Mar 20): $46.31

▼ **Price Target (Dec-20): $57.00**
Prior (Dec-20): $86.00

Square's investor update call struck the right tone on the unprecedented uncertainty created by COVID-19, balancing the interests of clients, shareholders and employees alike. SQ was tracking a couple points ahead of plan on both ecosystems through early March when it successfully raised $1B via a convert, then the virus impact started and accelerated such that the last 10-days saw a 45-point swing in Seller volume to -25%. 1Q revenue guidance was cut 2%, and FY20 guidance was unsurprisingly withdrawn. While Seller business is under pressure, Cash App (24% of net revenue) is holding up much better as a diversification hedge, and should benefit from pending fiscal stimulus. Again, SQ is well capitalized to outlast the virus as we previewed, and we like that SQ has levers to protect the bottom line and is hustling to better serve sellers (e.g. curbside pickup and delivery releases). We're cutting estimates and maintaining our OW assuming shares will gradually appreciate as investors gain more visibility into the longer-term impact of COVID-19 as SQ adapts, resulting in a new PT of $57 (from $86).

- **Guidance/JPMe Update Summary:** Our '20 and '21 SQ EPS estimates go to $0.65 (from $0.88) and $0.92 (from $1.36), respectively, on 2% (from 26%) and 16% (from 22%) total revenue growth, respectively. We now see a 10% GPV decline (from +22%) in '20.

	Updated 1Q20	Prior 1Q20
Total Net Revenues ($mm)		
Guidance	$1,300-$1,340	$1,340-$1,360
JPMe	$1,319	$1,351
Gross Profit ($mm)		
Guidance	$515-$525	$550-$560
JPMe	$522	$552

Source: Company reports, J.P. Morgan estimates.

- **Protecting the Seller, Defending the Earnings.** Management has been re-prioritizing roadmap items and cutting fees and adding features to help clients through the storm. SQ is expediting the launch of Seller-friendly, omnichannel offerings (detailed herein), while refunding March software subscriptions. Speed to market is a huge advantage, and we believe these initiatives are building goodwill that SQ could capitalize on in the recovery. SQ confirmed it has expense levers at its disposal (discretionary expenses ~50% of '19 Op. Ex.) and is adjusting loan origination requirements to minimize Square Capital risk.

- **TAM Update**. Square sees a $100bn market opportunity (SQ <3% penetrated) for the Seller ecosystem. The Cash App ecosystem offers a $60bn revenue opportunity (<2% penetrated) in the U.S. across sending, spending, and investing of funds. Square cited record Cash App first time user growth over the past week.

Payments, Processors & IT Services

Tien-tsin Huang, CFA AC
(1-212) 622-6632
tien-tsin.huang@jpmorgan.com
Bloomberg JPMA HUANG <GO>

Reginald L. Smith, CFA
(1-212) 622-6743
reginald.l.smith@jpmorgan.com

Andrew D Polkowitz
(1-212) 622-1219
andrew.polkowitz@jpmorgan.com

J.P. Morgan Securities LLC

Key Changes (FYE Dec)

	Prev	Cur
Adj. EPS - 20E ($)	0.88	0.65
Adj. EPS - 21E ($)	1.36	0.92
Revenue - 20E ($ mn)	5,962	4,785
Revenue - 21E ($ mn)	7,265	5,535

Quarterly Forecasts (FYE Dec)

Adj. EPS ($)

	2019A	2020E	2021E
Q1	0.11	0.12	0.25
Q2	0.21	0.10	0.20
Q3	0.25	0.19	0.21
Q4	0.23	0.26	0.26
FY	0.80	0.65	0.92

Style Exposure

Quant Factors	Current %Rank	Hist %Rank (1=Top) 6M	1Y	3Y	5Y
Value	80	82	88	93	
Growth	18	25	43	73	
Momentum	65	80	25	10	
Quality	8	63	52	73	71
Low Vol	76	79	85	82	
ESGQ	36	21	83	-	-

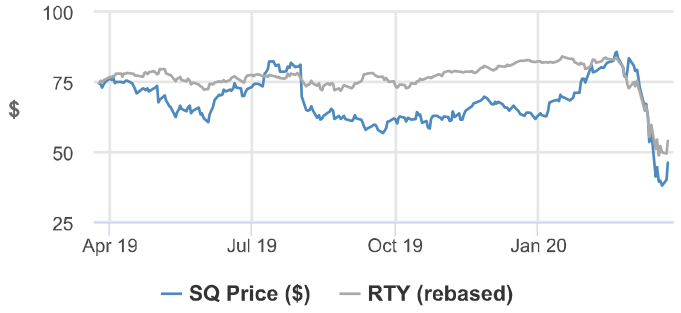
Sources for: Style Exposure – J.P. Morgan Quantitative and Derivatives Strategy; all other tables are company data and J.P. Morgan estimates.

See page 7 for analyst certification and important disclosures.
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Tien-tsin Huang, CFA
(1-212) 622-6632
tien-tsin.huang@jpmorgan.com

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Price Performance



	YTD	1m	3m	12m
Abs	-26.0%	-42.3%	-27.6%	15.7%
Rel	8.3%	-9.7%	7.1%	6.3%

Company Data

Shares O/S (mn)	498
52-week range ($)	87.25-32.33
Market cap ($ mn)	23,062.38
Exchange rate	1.00
Free float(%)	99.0%
3M - Avg daily vol (mn)	11.28
3M - Avg daily val ($ mn)	747.6
Volatility (90 Day)	85
Index	RUSSELL 2000
BBG BUY|HOLD|SELL	22|18|2

Key Metrics (FYE Dec)

$ in millions	FY19A	FY20E	FY21E
Financial Estimates			
Revenue	2,267	4,785	5,535
Adj. EBIT	341	322	457
Adj. EBITDA	417	405	540
Adj. net income	388	318	453
Adj. EPS	0.80	0.65	0.92
BBG EPS	0.78	0.87	1.26
Cashflow from operations	466	751	919
FCFF	350	330	833
Margins and Growth			
Revenue growth	44.0%	111.0%	15.7%
EBIT margin	15.0%	6.7%	8.2%
EBIT growth	79.9%	(5.5%)	41.7%
EBITDA margin	18.4%	8.5%	9.7%
EBITDA growth	66.3%	(2.7%)	33.1%
Net margin	17.1%	6.7%	8.2%
Adj. EPS growth	68.2%	(18.0%)	41.0%
Ratios			
Adj. tax rate	0.0%	0.0%	0.0%
Interest cover	-	-	-
Net debt/Equity	NM	NM	NM
Net debt/EBITDA	NM	NM	NM
ROE	27.4%	17.1%	20.5%
Valuation			
FCFF yield	1.6%	1.5%	3.7%
Dividend yield	-	-	-
EV/EBITDA	53.9	54.7	40.4
Adj. P/E	58.0	70.7	50.1

Summary Investment Thesis and Valuation

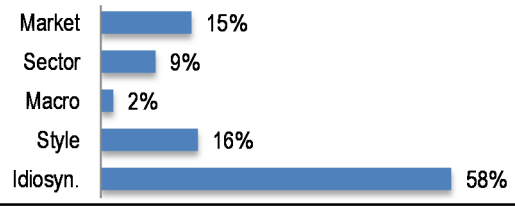
Investment Thesis

Square pioneered micro-merchant card acceptance, much like PayPal did for online payments and led the revolution to modernize software-based POS. Prior to Square, micro and casual merchants rarely accepted in-person card-based payments as mobile terminals offered by traditional POS technology providers were too costly, and banks were generally unwilling to underwrite merchant bank accounts for casual sellers. In just 10 years, Square has grown to ~$100bn in annualized card volume, serving nearly 3 million active sellers. It has also developed one of the largest Fintechs in Cash App to complement its seller business. We rate shares Overweight given Square's large and untapped addressable market, unique growth characteristics, and an equally unique mission and corporate culture, which, in our view, justify its premium valuation.

Valuation

We are reducing our Dec '20 price target to $57 (from $86) on lower estimates. Our new price target applies a 50x target EV/EBITDA multiple, in line with its average over the past three years. We think shares will appreciate from current levels as investors get more visibility into the longer-term impact of COVID-19 on Square's SMB merchant base.

Performance Drivers



Factors	6M Corr	1Y Corr
Market: MSCI US	0.03	0.37
Sect: Technology	0.42	0.34
Ind: Software & Serv	0.60	0.48
Macro:		
Crude Oil	-0.53	-0.16
Credit Spread	0.61	0.12
US 10yr Breakeven	-0.62	-0.10
Quant Styles:		
Growth	0.71	0.41
Size	0.40	0.23
Value	-0.60	-0.22

Source: J.P. Morgan Quantitative and Derivatives Strategy for Performance Drivers; company data, Bloomberg and J.P. Morgan estimates for all other tables.

Tien-tsin Huang, CFA
(1-212) 622-6632
tien-tsin.huang@jpmorgan.com

1Q20 Expectations Summary

Company Guidance

Based on the observed impacts to business brought upon by the COVID-19 crisis, Square lowered its net revenue and gross profit guidance. Net revenue guidance now is $1.30bn-$1.34bn (-2% revision at the midpoint), and gross profit guidance is $515mm-$525mm (-6% at the midpoint).

The revisions are largely driven by a 25% y/y drop in Seller GPV over a trailing ten-day period, which we note is decelerating further as we head into 2Q. Also worth calling out, the stated 25% is a blend Square's overall Seller base. Rates of deceleration vary by geography and vertical, but are most pronounced in New York, San Francisco, and Seattle (~45%). This is directionally consistent with the datapoints we've been tracking among small businesses.

COVID-19 impact has been less pronounced in the Cash App ecosystem, and gross profit has actually been running closer to targets with degradation in Cash Card.

JPM Estimate Updates

Our '20 and '21 SQ EPS estimates go to $0.65 (from $0.88) and $0.92 (from $1.36), respectively, on 2% (from 26%) and 16% (from 22%) total revenue growth, respectively. We now see a 10% GPV decline (from +22%) in '20.

Tidbits From Investor Call

Square Doing Its Part to Aid SMBs in Crisis

Speed to market is an advantage for SQ versus legacy players, evidenced by (1) recent release of curbside pickup (waving pickup & delivery fees for next 3 months), and a local delivery feature is pending to help sellers quickly adapt to limit in-person contact; (2) free online set up to promote digital gift cards to help drive cash flow; (3) refunding all software subscription fees (Appointments, Retail, Restaurants, Payroll, etc.) for the month of March; (4) customized emails to communicate with customers; (5) resources for sellers to connect with peers including webinars and best practice sharing. We believe these actions should reinforce the brand and build up goodwill for current and prospective sellers for payback when the economy recovers. We also like the idea floated by Womply (privately held software transaction/reputation data firm for SMBs) to allow payment companies like Square to deliver gov't stimulus directly to SMBs (think Square Capital funded by gov't via Square) as an example of something SQ could do at scale to aid SMBs.

Square Capital Appetite More Selective

Square recognizes sellers are in need to improve cash flow, and Square Capital can help, but given increased volatility we should expect the company to scale back on originations. Not surprisingly, Square has provided payment relief on existing loans (so we don't expect charge-offs to pick up materially in 2Q), and will increase/tighten loan requirements and credit standards for the time being, but we expect them to loosen these standards once things improve. Says relationships with investors are healthy on the funding side. Recall that Square had about $165M in loans held for sale on the balance sheet at the end of 2019.

Flexibility to Protect Bottom Line

On the call, management confirmed they will be pulling back previously planned investments where they do not expect immediate returns, although savings will be partially offset by the expedited launches of several omnichannel, seller-friendly initiatives referenced above (see *Square Doing Its Part…* section). On the cost side, management provided some color around its $1.5bn Op Ex base: ~50% discretionary spending across both ecosystems; ~20% related to customer acquisition and go to market spend; ~30% related to corporate overhead (including headcount). Discretionary spending will be the biggest source of cost savings, and we would expect M&A activity (and as a result related expenses) to slow until greater market stability prevails.

Well Capitalized

Square just raised $1B in a convertible note offering earlier this month providing the liquidity to not just weather this storm, but also invest in the recovery. Further, Square says it will maintain an asset light model for Square Capital and continue to sell loans to 3rd party investors. Recall that at the end of CY19, Square had ~$2B in cash, cash equivalents and investments in marketable debt securities.

TAM Update

Square sees a $100bn market opportunity for the Seller ecosystem, including $85bn in the U.S. with plans to implement new products and use cases and the longer terms goals of selling further upmarket and expanding into new geographies. The Cash App ecosystem offers a $60bn revenue opportunity in the U.S. across sending, spending, and investing of funds. In a post-social distancing world, we see this opportunity continuing to expand, and Square has already hinted at as much, citing record Cash App first time user growth over the past week. Square still has a long growth runway as it claims <3% and <2% share in the Seller and Cash App verticals, respectively.

Tien-tsin Huang, CFA
(1-212) 622-6632
tien-tsin.huang@jpmorgan.com

J.P.Morgan

Investment Thesis, Valuation and Risks

Square, Inc. *(Overweight; Price Target: $57.00)*

Investment Thesis

Square pioneered micro-merchant card acceptance in 2009, much like PayPal did for online payment 16 years ago, and has evolved to be the scale leader in the popular software-based POS revolution. Prior to Square, micro and casual merchants rarely accepted in-person card-based payments, as mobile terminals offered by traditional POS technology providers were too costly, and banks were generally unwilling to underwrite merchant bank accounts for casual sellers. In just 10 years, Square has grown to ~$100bn in annualized card volume, serving nearly 3 million active sellers. It has also developed one of the largest consumer Fintechs in the U.S. known as Cash App with over 15M users. We rate shares Overweight given Square's large and untapped addressable market, unique growth characteristics, and an equally unique mission and corporate culture, which, in our view, justify its premium valuation.

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Risks to Rating and Price Target

- Macroeconomic slowdown, especially in the SMB space where SQ is focused, and COVID-19 macro shock could place undue pressure on SMB sales volume and/or cause a spike in bankruptcies and pressure SQ's core revenue;
- Slower adoption/lower attachment rates of Square's value-added services, which represent a key part of the growth story;
- Downturn in the small business credit cycle or the inability to fund merchant cash advances, which would harm growth and profitability;
- Net margin compression due to increased competition or pricing pressure at the hands of larger SMBs;
- Square is focused on growth and scale, rather than maximizing profitability in the near term, which could turn off investors;
- Key man risk—CEO and co-founder Jack Dorsey is the visionary that drives the unique culture at Square and has helped attract key talent to the firm.

Tien-tsin Huang, CFA
(1-212) 622-6632
tien-tsin.huang@jpmorgan.com

J.P.Morgan

Square: Summary of Financials

Income Statement - Annual	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue	**1,575**	**2,267**	**4,785**	**5,535**	**-**
COGS	-	-	-	-	-
Gross profit	**-**	**-**	**-**	**-**	**-**
SG&A	-	-	-	-	-
Adj. EBITDA	**251**	**417**	**405**	**540**	**-**
D&A	(61)	(76)	(83)	(83)	-
Adj. EBIT	**190**	**341**	**322**	**457**	**-**
Net Interest	-	-	-	-	-
Adj. PBT	**190**	**319**	**318**	**453**	**-**
Tax	0	0	0	0	-
Minority Interest	-	-	-	-	-
Adj. Net Income	**226**	**388**	**318**	**453**	**-**
Reported EPS	0.47	0.80	0.65	0.92	-
Adj. EPS	**0.47**	**0.80**	**0.65**	**0.92**	**-**
DPS	**-**	**-**	**-**	**-**	**-**
Payout ratio	-	-	-	-	-
Shares outstanding	475	486	486	490	-

Balance Sheet & Cash Flow Statement	FY18A	FY19A	FY20E	FY21E	FY22E
Cash and cash equivalents	1,124	1,540	2,839	3,189	-
Accounts receivable	-	-	-	-	-
Inventories	-	-	-	-	-
Other current assets	988	1,680	1,466	1,718	-
Current assets	**2,112**	**3,220**	**4,305**	**4,907**	**-**
PP&E	142	149	141	144	-
LT investments	-	-	-	-	-
Other non current assets	1,027	1,182	1,182	1,182	-
Total assets	**3,281**	**4,551**	**5,629**	**6,234**	**-**
Short term borrowings	-	-	-	-	-
Payables	-	-	-	-	-
Other short term liabilities	1,019	1,694	1,488	1,676	-
Current liabilities	**1,019**	**1,694**	**1,488**	**1,676**	**-**
Long-term debt	900	939	1,939	1,939	-
Other long term liabilities	242	203	203	203	-
Total liabilities	**2,161**	**2,836**	**3,631**	**3,818**	**-**
Shareholders' equity	1,121	1,715	1,998	2,416	-
Minority interests	-	-	-	-	-
Total liabilities & equity	**3,281**	**4,551**	**5,629**	**6,234**	**-**
BVPS	**2.36**	**3.53**	**4.11**	**4.93**	**-**
y/y Growth	*27.7%*	*49.6%*	*16.6%*	*19.9%*	-
Net debt/(cash)	(224)	(601)	(900)	(1,250)	-
Cash flow from operating activities	**295**	**466**	**751**	**919**	**-**
o/w Depreciation & amortization	-	-	-	-	-
o/w Changes in working capital	-	-	-	-	-
Cash flow from investing activities	**(906)**	**95**	**(75)**	**(86)**	**-**
o/w Capital expenditure	(61)	(63)	(75)	(86)	-
as % of sales	*3.9%*	*2.8%*	*1.6%*	*1.6%*	-
Cash flow from financing activities	**516**	**(99)**	**623**	**(483)**	**-**
o/w Dividends paid	-	-	-	-	-
o/w Net debt issued/(repaid)	-	-	-	-	-
Net change in cash	**(102)**	**466**	**1,300**	**350**	**-**
Adj. Free cash flow to firm	**187**	**350**	**330**	**833**	**-**
y/y Growth	*79.8%*	*86.9%*	*(5.7%)*	*152.1%*	-

Income Statement - Quarterly	1Q20E	2Q20E	3Q20E	4Q20E
Revenue	**1,319**	**1,009**	**1,181**	**1,276**
COGS	-	-	-	-
Gross profit	**-**	**-**	**-**	**-**
SG&A	-	-	-	-
Adj. EBITDA	**78**	**69**	**113**	**146**
D&A	(20)	(21)	(21)	(21)
Adj. EBIT	**58**	**48**	**92**	**125**
Net Interest	-	-	-	-
Adj. PBT	**57**	**47**	**91**	**124**
Tax	0	0	0	0
Minority Interest	-	-	-	-
Adj. Net Income	**57**	**47**	**91**	**124**
Reported EPS	0.12	0.10	0.19	0.26
Adj. EPS	**0.12**	**0.10**	**0.19**	**0.26**
DPS	**-**	**-**	**-**	**-**
Payout ratio	-	-	-	-
Shares outstanding	486	486	486	486

Ratio Analysis	FY18A	FY19A	FY20E	FY21E	FY22E
Gross margin	-	-	-	-	-
EBITDA margin	15.9%	18.4%	8.5%	9.7%	-
EBIT margin	12.0%	15.0%	6.7%	8.2%	-
Net profit margin	14.3%	17.1%	6.7%	8.2%	-
ROE	23.7%	27.4%	17.1%	20.5%	-
ROA	8.3%	9.9%	6.3%	7.6%	-
ROCE	12.0%	14.6%	9.8%	11.0%	-
SG&A/Sales	-	-	-	-	-
Net debt/equity	NM	NM	NM	NM	-
P/E (x)	97.6	58.0	70.7	50.1	-
P/BV (x)	19.6	13.1	11.3	9.4	-
EV/EBITDA (x)	91.2	53.9	54.7	40.4	-
Dividend Yield	-	-	-	-	-
Sales/Assets (x)	0.6	0.6	0.9	0.9	-
Interest cover (x)	-	-	-	-	-
Operating leverage	143.9%	181.8%	(5.0%)	265.7%	-
Revenue y/y Growth	60.0%	44.0%	111.0%	15.7%	-
EBITDA y/y Growth	80.3%	66.3%	(2.7%)	33.1%	-
Tax rate	0.0%	0.0%	0.0%	0.0%	-
Adj. Net Income y/y Growth	96.3%	72.1%	(18.0%)	42.2%	-
EPS y/y Growth	75.9%	68.2%	(18.0%)	41.0%	-
DPS y/y Growth	-	-	-	-	-

Source: Company reports and J.P. Morgan estimates.
Note: $ in millions (except per-share data).Fiscal year ends Dec. o/w - out of which

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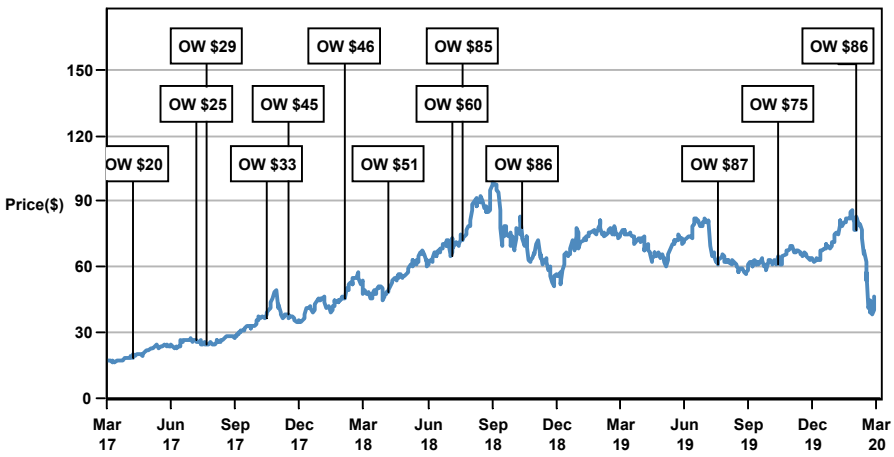
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Tien-tsin Huang, CFA
(1-212) 622-6632
tien-tsin.huang@jpmorgan.com

Square (SQ, SQ US) Price Chart



Date	Rating	Price ($)	Price Target ($)
04-May-17	OW	18.28	20
03-Aug-17	OW	26.46	25
17-Aug-17	OW	24.99	29
09-Nov-17	OW	36.71	33
12-Dec-17	OW	38.30	45
28-Feb-18	OW	45.91	46
03-May-18	OW	48.66	51
01-Aug-18	OW	64.65	60
14-Aug-18	OW	72.37	85
07-Nov-18	OW	77.31	86
15-Aug-19	OW	61.55	87
07-Nov-19	OW	61.34	75
27-Feb-20	OW	76.59	86

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Dec 14, 2015. All share prices are as of market close on the previous business day.

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