FinServ Acquisition Corp (FSRV): Katapult

The Leader In Nonprime US Consumer Lease-To-Own Payment Technology

Buy-Now-Pay-Later (BNPL) is one of the hottest spaces in the FinTech industry. Most BNPL companies serve prime customers (those with average/above-average credit score) like Affirm (AFRM) and Afterpay (APT.ASX). Yet, 38% of the US Consumer market are nonprime shoppers.

Enter FinServ Acquisition Corp (FSRV). The SPAC will merge with Katapult (sometime during 1H 2021), an innovative lease-to-own company dedicated to serving the 38% nonprime US consumer market. Katapult gives nonprime members the ability to buy the items they need with instant BNPL approval at the point of e-commerce sale. The company's experienced 100% origination growth each of the last three years and expects to generate ~$70M in 2021 EBITDA.

Katapult operates a two-sided value proposition model. The company serves over 1.4M customers and partners with 150+ online merchant platforms. Through Katapult, customers can buy goods they otherwise couldn't, which provides incremental revenue to Katapult's merchant partners through monthly lease payments and higher repeat purchases.

Lease-to-own is also a *highly* sticky business. Merchants have no reason to remove Katapult's service once embedded at the point of sale. Plus, customers enjoy having the choice to either buy now or pay in installments, regardless of creditworthiness.

Katapult's grown revenues from $43M in 2018 to $247M in 2020 (5.74x growth) and expanded EBIT from -$17M to $37M (15% EBIT margins). A fully diluted share count of 112M at the current stock price of $10.67 gives us a ~$1.2B market capitalization. Subtract ~$30M in net cash on the balance sheet, and you get $1.17B in Enterprise Value.

You can buy Katapult for 4.75x current sales, 28.5x current EBIT and get all the company's future growth for free. Even on a one-year forward basis, the value is compelling. Katapult expects to generate $450M in 2021 revenue and ~$60M in EBITDA. That's 2.60x sales and <20x EBIT!

To compare, Afterpay (APT.ASX) trades ~30x 2021 sales and >50x 2021 EBITDA. Repay, another competitor, trades at 12x 2021 sales and 28x 2021 EBITDA.

Mr. Market sold off Katapult after competitors like Affirm (AFRM) went public. Yet, the current price implies Katapult's business is worth a 6.7% premium to $300M cash in a trust account. Katapult has penetrated <1% of its addressable market. Plus, it's the only pure-play e-commerce BNPL operator serving nonprime customers purchasing consumer durable goods. If Katapult trades remotely close to its peers on an EV/Sales or EV/EBITDA basis, it is worth **$30-$45/share (228%+ upside)**.

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A Big Fish In A (Relatively) Small Pond

Katapult's lease-to-own service isn't new by any means. But it's *where* Katapult exercises the technology that makes it unique and offers moat potential. The company is the only BNPL operator addressing the *massive* nonprime US consumer market.

The company's target market is nonprime consumers purchasing durable consumer goods like furniture and home appliances. The durable goods consumer e-commerce market is a $180B business set to reach $300B by 2023. Katapult estimates that nonprime customers account for $40B - $50B of that $180B market.

Katapult took a vast market (consumer e-commerce) and refined it *only* durable goods. From there, they further filtered its target market to $40B - $50B. In doing so, the company found its niche and created its competitive advantage. Moreover, Katapult has only captured <1% of its "small" niche market, offering decades of revenue runway.

Before we dive into product specifics, we should know *why* a consumer would choose to pay with Katapult and *why* a merchant should accept Katapult as a payment service.

Why Consumers & Merchants Choose Katapult

Two-sided propositions where both the customer and the merchant win usually make great investments. This makes intuitive sense. If the customer loves using a product and benefits the one selling a good to the customer, why switch?

Katapult benefits both consumers and merchants. For consumers, Katapult provides flexible lease-to-own payment plans so nonprime members can buy household items like fridges and furniture. Leveraging Katapult's 100% digital platform, consumers get approved in <5 seconds without a credit score at the point of purchase. After buying, consumers have access to flexible, transparent payment options with no late fees ever.

Simultaneously, Katapult offers merchants exposure to incremental customers that wouldn't have purchased their product without a BNPL option. The benefits of Katapult's extended reach are many. First, Katapult allows higher conversion rates and helps reduce abandoned shopping carts. Second, Katapult fosters higher repeat purchase behavior. 48% of Katapult customers become repeat customers. Third, offering a lease-to-own payment option increases customer loyalty and brand affinity. Merchants that provide Katapult experience a ~58 point increase in NPS scores.

Let's see an example of Katapult in action.

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How Katapult Works: Transaction Example

Say you're a nonprime US consumer that needs a new fridge. You don't have the money to pay for one today, but you *need* one today. After researching brands, you find a Samsung fridge for $700 at Home Depot.

Luckily, Home Depot partners with Katapult, so you can buy the fridge now, then pay for it over 12 months.

Katapult's payment plan is simple. The company charges a one-time $45 initiation fee and then "loans" the customer 2x the good's purchase price. In our example, that means we pay $45 + $1,400 over the 12-month life of the lease.

I know what you're thinking. Who would *voluntarily* pay *twice* the amount for a product? It's not the only choice. Customers can pay the item's full price within 90 days of purchase for a 5% fee. Using our above example, if we paid before 90 days our total cost would be $700 (price of good) + $35 (5% fee) + $45 (initial fee), or $780.

Choosing the 90-day payment option, customers pay an 11% premium on the product to better control personal cash flow. That's a good trade. Plus, Katapult never charges a late fee.

The danger with any BNPL provider is charge-offs and recoveries. In addition, nonprime consumers *tend* to have lower credit scores (read: lower creditworthiness). This means Katapult needs a top-notch underwriting system to deliver consistent profit margins.

Luckily they've got the proprietary tech to back it up.

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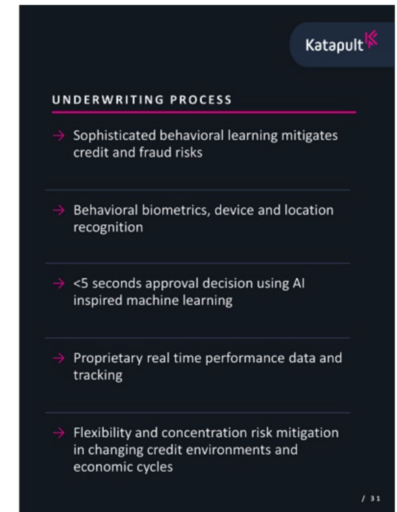
Katapult’s Technology: More Data = Better Product

The company assigns each customer a score using its proprietary technology platform. Think of it as a credit score. Instead of using actual credit scores, Katapult leverages various attributes for decision-making, including:

- Lease history
- Prior payment behavior
- Behavioral biometrics
- Shopping behavior
- Mobile device information
- Cart information



Each score uses *at least* seven user inputs and up to ~100 total user attributes. The goal of any BNPL platform is to reduce fraud rates and improve lease cost recoveries. Katapult’s model performs better than most. We see this in False Positive percentage rate data.

For example, at a 70% accurate positive rating, Katapult experiences a ~23% false-positive rate (approved customer isn’t capable of paying off the purchase). However, at the same 70% true positive rating, the average 3rd party off-the-shelf BNPL provider generates a ~57% false-positive rate. That’s more than double Katapult’s error rate.

Katapult sports a <3% fraud rate across its lease-to-own portfolio. And when it misses, the company recovers 80-90% of the lease cost on charge-offs.

The platform relies on Katapult’s proprietary machine learning approval algorithm. As we discussed in the essay *Great AI Companies: What They Are & How To Find Them*, these algorithms improve the more data you feed them.

This means that false-positive and fraud rates should decline over time, resulting in a higher contribution margin per application. In addition, given that Katapult’s playing the niche game, it’ll have a data advantage over its peers within the nonprime US consumer segment.

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Katapult Doesn't Need Lots of Cash To Grow

One of the benefits of BNPL operators is that they can offload most of their sales/marketing to their merchant partners. As we noted earlier, Merchants see Katapult as a way to capture incremental customers that otherwise couldn't afford their products.

So it makes sense that merchants push Katapult to their customers as a potential payment option. This enables Katapult to invest in other areas of its business, like product development and enterprise sales.

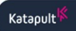
Here's an example of Katapult's cash-light investment needs. The company outlined three strategic investment opportunities for the coming years:

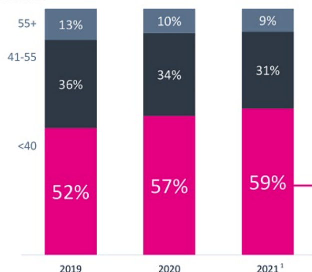
- Sales & Marketing: $8-12M
- Enterprise Sales: $5-10M
- Technology: $4-6M
- **Total Multi-year investment amount:** $26M (on the high end)

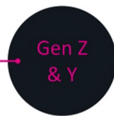
Katapult expects to generate ~$450M in revenue this year. In other words, the company's multi-year investment plan consumes ~5.6% of this year's revenue estimates. The remaining cash flows through to the bottom line. Management can reduce debt or pay back shareholders via special dividends/buybacks.

What's The Size Of The Prize?

The nonprime durable goods e-commerce market is a $40-$45B market. By 2023, the company expects its market to balloon to **~$75B**.







Katapult has <1% of its current target market. How can the company expand its market share? In short, by approving more online shoppers for its BNPL offering. We can better understand Katapult's potential customer pool through the Prime Lending Waterfall Effect.

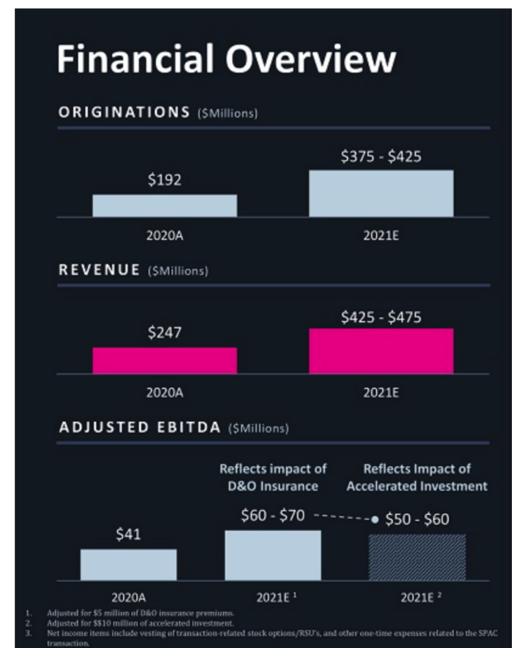
Let's assume 1M customers apply for prime lending lease-to-own offerings. Of that 1M, roughly 65% (or 650,000) applications get declined. **This 650K is Katapult's addressable market.** From there, the company expects to approve ~60% of those previously declined applications, giving us 390K new approvals.

Katapult then estimates that ~60% (195K) of those approved will convert to paying leases. At an average order value of ~$600, that's an incremental $117M in incremental originations per 1M prime lender applications. Assuming the company's 1.28x revenue multiple on originations, you get $150M in incremental revenue per 1M applications.

COVID-19 cemented e-commerce as the go-to shopping experience for 99% of consumer products. In turn, more customers will opt for flexible financing like Katapult as a way to pay for goods while controlling personal cash flow.

How Much Is Katapult Worth?

FSRV trades at ~$11/share at the time of writing this report. At a fully diluted share count (112M), that's ~$1.23B in market cap. Add back the company's ~$30M net cash position, and you get $1.2B in Enterprise Value.



Let's assume that Katapult grows top-line revenue at a ~60% CAGR for the next five years, giving us $2.6B in revenue by 2025. Next, let's assume the company expands its Gross Margin by 2-3% given improvements in its Machine Learning algorithm. That gets us 35% Gross Margin on $2.6B in revenue or $898M in Gross Profit.

Given the expanded Gross Margin, Katapult's EBIT margins should improve ~2-3% to 17% as its scalable business model takes shape. This gets us $436M in operating income. Subtract interest and taxes, and you're left with ~$290M in after-tax cash flow (4.4x multiple).

In other words, you're paying **~11x 2023E after-tax operating income and ~1x 2023E EV/Sales for a capital-light FinTech business growing revenues at a 60% CAGR with double-digit EBIT margins in a massively underpenetrated industry.**

Given Katapult's peer valuations, a 25x multiple on 2023 EBITDA seems fair. That puts us at a ~$5B market cap, or **~$45/share (~300% upside)**.

Risks & Concluding Thoughts

There are a few main risks associated with a Katapult investment. First, there's customer concentration. Wayfair is ***by far*** the company's largest customer at 70% of total revenue. However, this issue should resolve as more merchants adopt Katapult's BNPL offering in the coming months and years. In fact, just two days ago, the company announced that it partnered with another 26 merchants during Q1. That's well ahead of its goal of 50 new sign-ups during the entire year.

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Second, the lease-to-own space is one of the most competitive pockets in the FinTech industry. Katapult competes with behemoths like Affirm, Afterpay, and even PayPal. Each wielding more substantial balance sheets and ample cash to throw at the nonprime US consumer space. Katapult earns decent EBIT margins in its business, which should attract further competition.

Then you have credit risk with the company issuing 12-month loans to nonprime US consumers (i.e., consumers with <700 credit ratings). Such customers are riskier borrowers in the eyes of traditional credit lenders, which raises the potential loan loss probability.

The good news is that you're not paying up to watch this business grow its customer base, expand margins, and take market share in its $45B industry. You also have the added comfort of investing alongside long-term funds like Iridian Asset Management (which owns 20% of the company), Sachem Head Capital (owns another 10%), and Tiger Global Management (led the latest PIPE).

Other Portfolio News & Notes

We've got updates on two of our largest positions: POWW and HCITY.

POWW Raises Revenue & EBITDA Guidance (Again)

On Wednesday, POWW issued a PR updating its FY 2022 revenue guidance to $190M. That's a $70M increase from its $120M projection in April. Moreover, Wagenhals estimates that POWW will generate ~$65M in EBITDA during FY 2022.

Usually, I'm cautious whenever management gets aggressive and updates revenue targets MoM. Yet POWW's hit (or surpassed) each of its previous guidance, giving me confidence they'll get there again this year.

Here's the crazy part. You can buy POWW for **~3x next year's estimated sales** and **8.8x next year's estimated EBITDA.** The company's growing top-line revenue at a triple-digit CAGR and expanding EBITDA margins from *negative* to 35%. At this rate, POWW will generate its current market cap in revenue before 2025.

POWW needs a ~43% revenue CAGR till 2025 to hit its market cap in sales. Tough, but possible given the growth we've seen the last few years. Stick a 5x sales multiple on 2025 revenue, and you get ~$2.76B in Enterprise Value and **~$29/share in shareholder value**.

Mexican Hotel Occupany Is Back!

HCITY, our Mexican hotel operator, should report positive free cash flow this quarter, according to Fibra Inn's latest press release.

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Fibra Inn is a Mexican real estate investment trust specialized in the hotel industry. The company issued its April 2021 hotel indicator results this week, and the recovery looks good (see below):

MONTHLY SAME-STORE SALES			
15 hotels	Apr 2021	Apr 2020	Change %
Room Revenue (Ps. millions)	41.2	13.0	216.6%
Occupancy	46.0%	15.2%	30.8 pp
ADR (Ps.)	1,180.0	1,153.9	2.3%
RevPar (Ps.)	542.3	174.9	210.1%

TOTAL MONTHLY SALES			
	Apr 2021	Apr 2020	Change %
Number of hotels	33	15	
Room Revenue (Ps. millions)	78.3	13.6	475.9%
Occupancy	37.4%	12.8%	24.6 pp
ADR (Ps.)	1,254.0	1,163.1	7.8%
RevPar	468.6	148.4	215.8%

Every hotel metric improved YoY. For example, room revenue is up 475%, Occupancy rates up 25%, and Average Daily Revenue (ADR) increased nearly 8%.

These improvements bode well for HCITY, and we should see them reflected on the income statement. Remember, we didn't need much to go right for us to make a lot of money. All we needed was the company to survive. Anything else is icing on the cake.

Also, if you're a new Collective member and haven't read our write-up, check it out here.

The stock's pulled back towards its 200MA over the past two weeks (see below), giving new Collective members an excellent entry point. We'd buy more here, but it's already a ~13% position.

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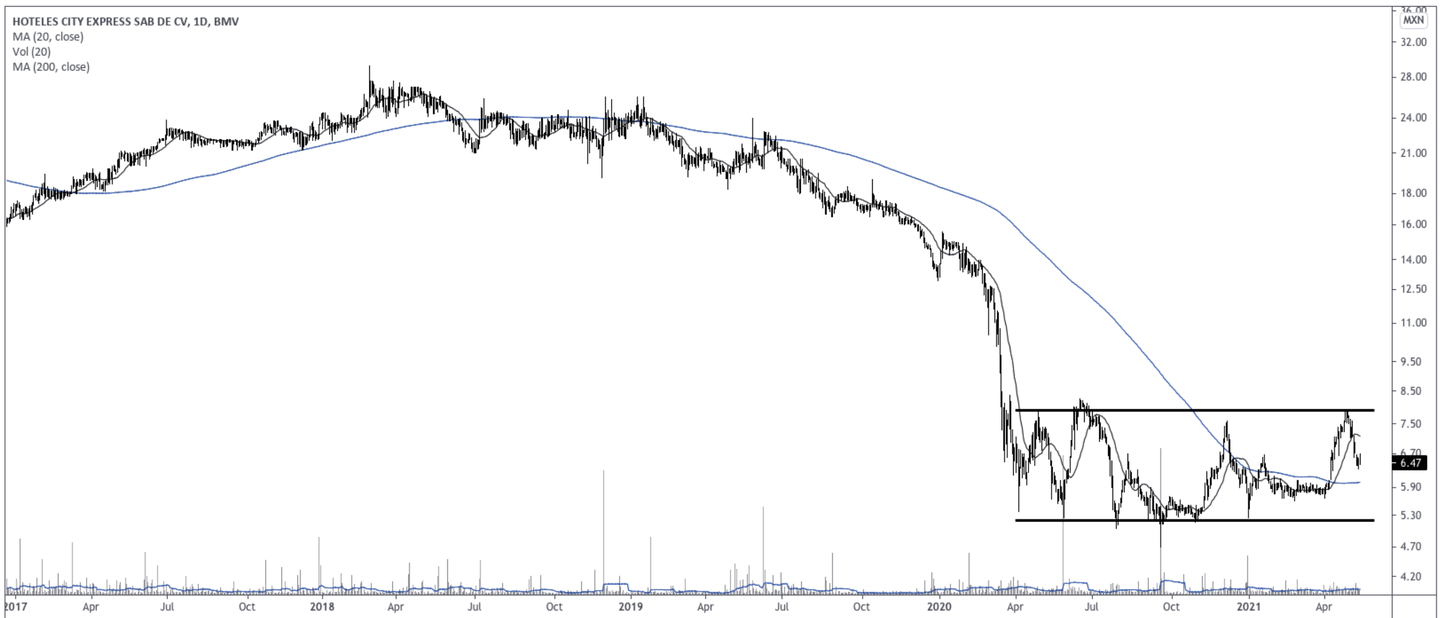

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