Riskified (RSKD): One Of The Most Exciting Soon-To-Be IPOs of The Year

Making eCommerce Safe, Accessible, and Frictionless For Merchants

Riskified (RSKD) provides frictionless fraud management for eCommerce merchants. They do this by leveraging its global merchant platform with over 1B transactions to identify fraudulent purchases *before* they happen.

The company makes money by charging a small fee for each merchant transaction approved on its platform. Here's the best part. RSKD *reimburses* merchants for every legitimate transaction it declines (or Chargeback Guarantees). In other words, RSKD pays merchants if it denies a legitimate customer purchase. Such a business model creates *perfect* company-customer alignment. Here's how.

RSKD is incentivized to approve as many transactions as possible for its merchants while at the same time ensuring the highest level of accuracy in its approval process.

Merchants win because they see higher numbers of approved transactions (i.e., higher sales). RSKD wins because it can feed more transactions into its global merchant platform.

Riskified's global merchant platform begets massive network effect advantages over time. The more merchants RSKD has on its platform, the better data it collects for its risk management algorithm. This improved data leads to a more accurate approval model.

The result is a product that helps merchants increase sales, reduce operating expenses, and create a better customer experience at a fraction of the cost of in-house alternatives.

We'll dive into its history, value proposition to merchants, and why Riskified is the *clear* winner versus its competition.

Solving The Chicken And Egg Problem

Eido Gal and Assaf Feldman founded Riskified in 2013 to help improve eCommerce for merchants and customers. The team began as a one-trick pony, offering fraud solutions that allowed merchants to approve orders they would've otherwise declined.

The pair created a machine learning (ML) algorithm to decipher good transactions from bad. This first flagship product remains at the core of Riskified's business. Only now, the ML model is exponentially better at finding legitimate transactions while rejecting fraudulent attempts.

As we mentioned earlier, Riskified benefits from massive network effects where more merchants on the platform increase the platform's value for every other merchant. But it wasn't always that easy.

Gal struggled to find Riskified's first customers. And when they did, the process was more human than machine learning.

Gal explains in his initial pitch to early customers in a [2010 LinkedIn article] (emphasis mine):

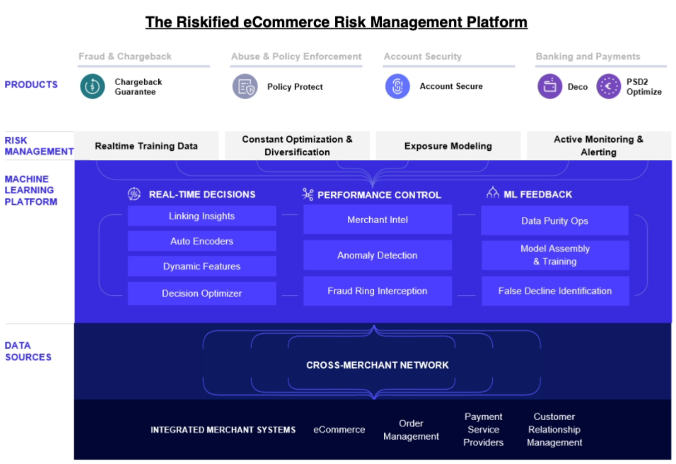
> *"Our early sales pitch was this: send us the orders that you were going to decline, we'll review them and find the treasure in your trash."*

Even with the attractive pitch above, the company *still* had issues finding initial customers. There were two main reasons for this:

1. How merchants thought about fraud prevention
2. Gathering enough data (i.e., setting the flywheel in motion)

At that time (2013), merchants saw fraud prevention only as a one-way street revolving around chargebacks. To merchants, lower chargeback rates equaled lower fraud cases. There's just one problem with that approach. Merchants were blind to the hundreds of thousands of declined orders that were *legitimate* purchases, as Gal explains (emphasis mine):

> *"We had conversations where merchants had low chargeback rates while declining huge numbers of orders,* ***and they were convinced that all of those declined orders were from fraudsters.*** *So we had to convince them that they had a problem."*



The second problem Riskified encountered was lack of data or the classic "chicken-and-egg" problem. Riskified's ML model *needed* real-time data to train, test, and run its fraud prevention algorithm. To get that data, it requires customers to agree to use the product.

To solve the chicken-and-egg problem, Riskified offered merchants a zero-risk proposition … "give us all the rejected orders and we'll see if we can find legitimate purchases."

Riskified went a step further, guaranteeing order values for purchases the company approved using its platform. **The result was a risk-free chance at incremental revenue at no cost to the merchant.**

The company invented the "chargeback guarantee" model, and it's what distinguishes RSKD from its competitors today.

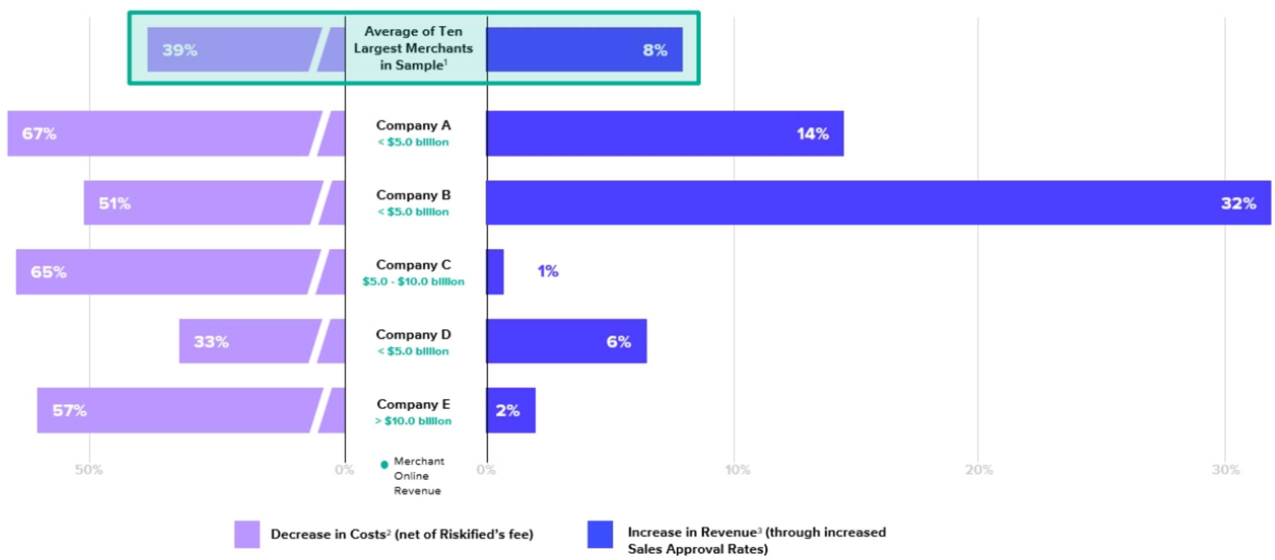
But to *truly* understand the power of RSKD's offering, we must know the challenges merchants face when confronting eCommerce fraud.

Merchant Decisions and Frictionless Expectations

Merchants face a tricky problem. Armed with little information, they must choose which consumer transactions to accept and which ones to decline. Oh, and they have to answer that question instantaneously, or they'll use the purchase.

Put simply, merchants choose between growth **or** security. Avoiding (seemingly) risky customers may reduce fraud, but it stipends potential revenue growth. On the other hand, high approval rates lead to increased fraud and a worse customer experience.

Revenue and Cost Impact to Largest Merchants Sampled



Moreover, consumers are growing ever-accustomed to a "frictionless" shopping experience. Things like one-click payments and credit cards stored on file are features we *expect* from our favorite online merchants. Yet, they pose an increasing challenge in fraud prevention as legacy partners add friction to such an experience.

Now that we understand the decision-making process from the merchant's perspective, let's examine specific types of fraud and how legacy (i.e., non-Riskified) competitors address the issue.

Types of eCommerce Fraud/Friction & Legacy (In-House) Solutions

Merchants face numerous fraudulent attacks from friend and foe. Fraud comes in many forms, including:

- Stolen payment credentials
- Compromised consumer accounts
- Illegitimate refund claims

- Impersonating legitimate consumers

Any of the above issues lead to declined transactions and frustrated consumers. Add to that banking and payment infrastructure that refuses purchases for internal reasons. According to The Economist, an estimated 10% to 15% of online orders are declined by issuing banks.

eCommerce merchants face these challenges daily, and they have two choices on how to combat them:

Build an in-house risk prevention system *or* ***Use Riskified***

In-House risk prevention systems require loads of time, energy, and money. These are resources that could help merchants do what they do best and sell products to customers. Merchants use a combination of legacy point solutions, third-party data sets, and a large internal staff to manually review individual transactions. The result is like putting a band-aid on a bullet wound.

These in-house systems create false declines and increase lost sales. For example, Riskified's ten largest merchants rejected ~8% of their total transactions on average before using Riskified's platform.

Then there are the third-party data issues. Merchants building their in-house system use a combination of their data plus smaller sets of third-party transactions. These small sample sizes lead to incorrect models and lower accuracy rates.

It's easy to see why in-house systems fail merchants. Merchants aren't in the business of building fraud prevention software. They're too busy selling products to customers.

Riskified takes care of merchants' fraud prevention solutions because that's its only job as a company. And it does it very well.

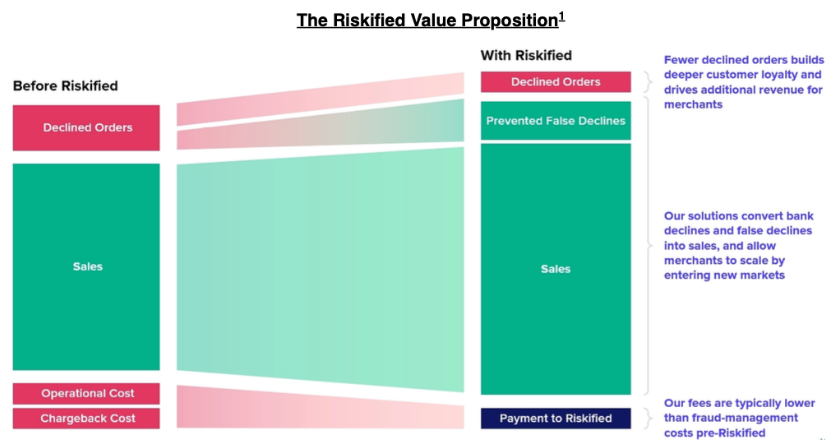
Why Riskified Beats The Competition

The RSKD competitive advantage is simple and one we've seen in our Cardlytics (CDLX) thesis. In short, the RSKD risk management platform benefits from network effects where the platform's value increases as the company add new merchants.

It's taken the company eight years to build its ML model. Now, its algorithm draws from over 1 billion historical transactions, each with 100+ data attributes. This is an example of defensible data. It would take in-house merchants *decades* to replicate the amount of data RSKD has in their platform. This makes RSKD's ML algorithm exponentially better than anything in-house from any individual merchant.

As more merchants join the platform, RSKD's model will better predict fraudulent behavior. Better prediction leads to higher approval rates for merchants and more revenue from Riskified.

Even better, greater accuracy leads to reduced Chargeback Guarantee payments RSKD makes to merchants, resulting in higher gross margins.



You can see the perfect incentive alignment at work.

Riskified provides five main products to its merchants:

- ***Chargeback Guarantee:*** Riskified's Core Product -- automatically approves or denies online orders with guaranteed performance levels that vary by our merchants' priorities
- ***Policy Protect:*** Helps merchants identify consumers that may be taking advantage of a merchant's policies in ways that are abusive and expensive to the merchant
- ***Deco:*** Helps merchants combat bank authorization failures during the checkout process
- ***Account Secure:*** Helps prevent a consumer's saved account with a merchant from being compromised by a fraudster.
- ***PSD2 Optimize:*** Enables merchants to minimize the effect of the EU's Payment Service Directive 2 regulations on their eCommerce business

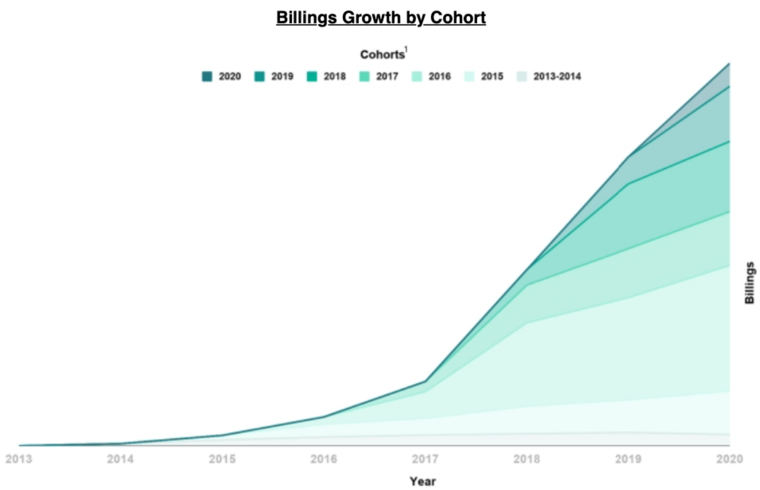
Through these products, Riskified increases sales, reduces operating costs, and optimizes the consumer shopping experience.

For example, RSKD's ten largest merchants experienced an 8% increase in revenue and a 39% decrease in fraud-related operating costs and chargeback expenses on average, *net of RSKD fees.*

To do this, Riskified must embed themselves in the guts of their merchants' payment stack. The company elaborates on this in the F-1 filing (emphasis mine):

> *"We have differentiated access to our merchant's transaction data through* ***deep integrations into their mission-critical infrastructure, including their eCommerce, order management, and customer relationship management systems.*** *Collecting relevant data across our merchant network allows us to identify complex transaction and behavior patterns that are not*

easily identifiable by merchants on their own. Our ability to help our merchants stems from the fact that we continuously feed this real-time training data into our sophisticated machine learning models."



This explains RSKD's 122% Net Dollar Retention Rate over the last year.

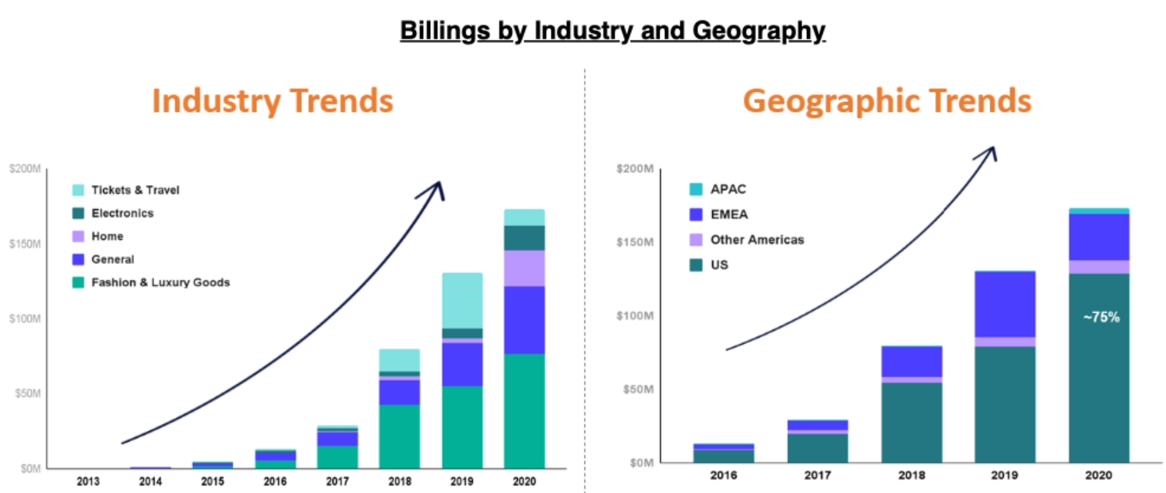
Yet more deeply ingrained than RSKD's data models is the company's trust guarantee with its merchants. RSKD guarantees a minimal approval rate for its merchants, which is often higher than its own approval rates. Plus, RSKD will reimburse the merchant for any legitimate sale discarded as fraud through the RSKD platform.

That merchant-company trust relationship creates a stickiness that can't be measured in dollar retention yet is arguably more potent than any infrastructure-led switching cost.

RSKD Current Merchants & Size of Opportunity

The company usually targets enterprise eCommerce merchants or merchants generating over $75M in annual online sales. Some familiar customers include Wish, Wayfair, REVOLVE, Finish Line, Macy's, StockX, and GymShark.

75% of RSKD customers are US-based, with the majority selling Fashion and Luxury Goods products.



RSKD ran $63.4B in GMV through its Risk Management Platform last year. Of that $63.4B, the company recognized $169M in revenue for a 0.27% take rate. Over the previous two years, RSKD had increased Gross Profit Margin from 48% to 55% in 2020.

Given RSKD's data advantage, the company will expand margins as its algorithm increases approval rates, reduces chargeback costs while adding more merchants to the platform.

So what's the size of the prize? Global eCommerce grew 28% last year to $4.3T and is expected to reach $6.4T by 2024. It's important to note that 85% of online eCommerce sales were driven by merchants with $75M+ annual sales, which is RSKD's target customer base.

Various research reports suggest that the global eCommerce Fraud Prevention TAM ranges between $20B and $62B, depending on how far you extrapolate growth rates. Let's take the short end of $20B. That means RSKD has tapped less than 1% of its addressable market.

Of course, the company won't reach 100% market penetration, but what about 30% or $6B? Riskified has only tapped ~3% of *that* addressable market.

Concluding Thoughts

Riskified is one of the most competitively advantaged businesses situated in one of the fastest-growing industries globally. The company benefits from a decade's head-start data advantage and inferior in-house solution alternatives. RSKD's platform will only improve over time. With it will come increased operating margins and durable free cash flow generation.

The company makes it easy for merchants to scale revenues without worrying about fraudulent purchases. In fact, RSKD guarantees minimum approval rates and even pays for the times it gets it wrong.

This trusting relationship allows merchants to do what they do best, sell more products to their customers.