MO Weekly Equity Note: 09-18-2021

Digging Into Riskified's (RSKD) Competitive Positioning, Deco Banking Product, and Card Issuer Dynamics

This week we bought a starter position in Riskified (RSKD). RSKD provides frictionless fraud management for eCommerce merchants. They do this by leveraging their global merchant platform that processes over 1B transactions to identify fraudulent purchases *before* they happen.

We're extremely bullish about the company and the current market price. RSKD serves one of the fastest and largest global industries, eCommerce retailing. We bought our shares at a ~$4B market cap and we think the opportunity in this space is 10-20x that price. Such highly asymmetric opportunities don't come around often and our job is to buy them when they happen.

You can read our original write-up here.

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 fraudulent transaction it approves through its platform (aka Chargeback Guarantees).

In other words, RSKD pays merchants if it approves a transaction that they should've declined. This business model creates perfect company-customer alignment.

RSKD is currently a ~3% position. The majority of the company's share lockup expires around November. At that point, we'll likely add another 3% risk to get to a 6% position at cost.

This weekend, we're diving into RSKD's competitive positioning in its industry, how its *Deco* product could be worth half its current market cap in three years, and the dangers of high chargeback rates.

There's a lot to cover, so let's get after it.

RSKD's Competitive Positioning: How Do They Stack Up?

There are ~5 options to choose from when it comes to fraud prevention:

- Signifyd
- Sift
- Forter
- Kount
- Riskified

We can split these businesses into two main categories: Chargeback Guarantee and Non-Chargeback Guarantee (aka, score-based model)

Riskified and Forter operate the Chargeback Guarantee model, whereas Kount, Sift, and Signifyd offer a score-based model. The fundamental difference between the two is that one makes a decision, and the other generates a score that leaves the decision up to the merchant.

Customers typically prefer Riskified or Forter because of the chargeback guarantee. That's not to say the other companies don't serve a purpose. In fact, multi-billion dollar retailers might use the non-chargeback guarantee product if they have the resources to build their own in-house fraud team.

That said, the economics don't work for the *majority* of those that try to take this in house. We explained in our original write-up (emphasis mine):

> *"**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."*

For our purposes, the *real* apples-to-apples comparison lies in Forter vs. Riskified.

Let's examine the similarities and differences between the two.

Forter & RSKD In Action: Similarities and Differences

It's important to note that Forter and Riskified sport highly similar business models. Both use Machine Learning (ML) models to conduct fraud decisions at the point of payment authorization.

This makes sense given that both founders came from the same PayPal fraud company, *Fraud Times*. Riskified's former Director of Sales explains the creation of both companies:

> *"And both Riskified CEO and Forter CEO came from the same place, okay? They started at exactly the same time with exactly the same business model and the same methodology. They were all providing this new Chargeback Guarantee business model for fraud prevention for declines for something that they used to call in Fraud Times stretch to treasure, which is taking the declined transaction and turning them into revenues based on machine learning and back in the day also using fraud analysts to look at transaction."*

Let's use a real-world example from the Head of Global Fraud Prevention at MatchesFashion.com (via Tegus).

MatchesFashion uses both Riskified and Forter in its fraud prevention, with each serving a unique purpose. The executive noted that Forter performs better in the Americas than Riskified. RSKD, on the other hand, outperforms Forter in the rest of the world, leading in most countries, including Italy, Canada, United Kingdom, France, and 47 different countries.

So, Matches would split its revenue between RSKD and Forter, with Forter taking the Americas and RSKD taking international sales.

This sales split is standard amongst larger e-commerce companies. Sky-Tours is a great example. One Chairman explained how they use both RSKD and Forter in their fraud process (emphasis mine):

> *"So **we use Forter for low-cost carriers.** But for other IATA tickets we issue and we have a voidability until 24 hours or 12 at night in the evening. We do not need their confirmation immediately and we can wait for the confirmation.*
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> *The thing is **Riskified is more accurate. If they can't do it right away, they don't say no as Forter does.** They say captured and then they look into it and maybe some minutes later or some hours later, we get the confirmation from them or they say, no, we cannot confirm.*
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> *And of course, because of that, we don't have to issue the ticket, IATA tickets immediately, instantly. We can wait for that. **So that's why we have both. Forter, when we cannot wait at all. And Riskified when we can wait**."*

There are three significant differences between Forter and RSKD. The first is **the speed of decision-making.** For example, Forter is 100% automated. It's a yes or no. There's no gray area. RSKD takes a more cautious approach.

The company combines the power of computers with the familiarity of humans to create an elegant experience for its customers. Additionally, RSKD provides each merchant with its own account executive. This person's job is to help the merchant find additional "free" revenue, something Forter doesn't do.

Here's an example of Riskified creating "free" revenue for its customers (via Tegus):

> *"So what our analysts do, the people who work in account management, they actually have access to all of our customers, like order information. So even though we're providing our service on a small segment, we have time to analyze where the rest of your orders are coming in from.*

> *So we can tell you, "Hey. Look, we know that you're systematically canceling all orders from Taiwan. But actually,* ***we recognize these transactions and the rest of our network, and we guarantee you that these are clean transactions. You will not get a chargeback from them"***
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> *So if you really wanted to,* ***you could expand your pocket of population to include all orders from Taiwan, make a couple of extra million dollars overnight for free.*** *Like you're not doing anything. You're not increasing marketing. You're not increasing your product reach or anything.* ***You're literally just better managing your online payment terminals and your internal rules.****"*

The second significant difference is **the pricing structure**. Forter usually charges a flat fee per transaction, while RSKD charges a percentage of transaction volume (~1%). This transaction-based pricing model explains Forter's recent shift in business strategy and why it left RSKD as the only Chargeback Guarantee company. Let's see why.

Forter's Pricing Model: "We'll Make It Up In Volume."

According to *BuiltWith*, Forter works with 10,358 live websites. This is nearly *five times* the number of Riskified sites (2,337). The reason for such a significant difference? Forter's aggressive "win-at-any-cost" customer acquisition strategy.

Forter made a strategic effort to distance itself from such a liability-heavy offering. A former Riskified Director explains Forter's model drift (emphasis again):

> *"And what happened in recent years, in the last, let's say, two years,* ***Forter drifted away from the Chargeback Guarantee model. And now they barely offer it, okay?*** *So now Forter has something that is a bit different. It calls nonguaranteed decisions, meaning you are still getting a decision, a yes or no approval decline, but without the liability shift.*
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> *So they were more flexible, and it enabled them to work with more companies. And it enabled them to work with more companies in a way that more* ***companies will send them bigger portions of their volume because it's much cheaper than going with the liability shift, but it generates significantly less revenues on deals.*** *So if you compare a nonguaranteed decision deal to a guaranteed decision deal, there might be a 10x difference on the deal from a size perspective.*
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> *But it enabled them to build a very strong network. And I think that Forter also expanded to China earlier than Riskified, definitely earlier than Signifyd. So I think that none of the companies are strong in Asia yet. And I think that that's another frontier that is going to be a very lucrative market for these companies.*

> ***Riskified is the only major player in this space that is still doing only Chargeback Guarantee.*** *Signifyd started to do also nonguaranteed decisions. Forter drifted almost completely away from Chargeback Guarantee."*

Forter's pricing model crystallized the company's business model transformation. Remember, the company charges a flat rate on each transaction. For example, on a $100 transaction, Forter charges $0.05 while RSKD charges 1% (or $1).

At first glance, RSKD looks significantly more expensive. But they're also taking total liability for any chargebacks. On the surface, Forter will *always* generate higher per-unit gross margins because they don't have to cover for chargebacks.

However, gross margin isn't the complete picture. Sure, Forter makes a higher margin per transaction, but they're only charging $0.05 on a hypothetical $100 transaction.

RSKD, on the other hand, generates 50-60% gross margins on the 1% take rate, or $0.50 per $100 transaction.

In other words, RSKD generates substantially more profit-per-transaction than Forter.

That's why Forter switched its business model to focus on non-Chargeback Guarantees. They have to make transaction profits up in volume.

Now, RSKD is the only player with the most customer-aligned business model in the industry.

Chargeback vs. Non-Chargeback: Which Side Will Win?

There's a clear trend developing in the fraud prevention/protection space. Besides Riskified, every fraud prevention company is opting for a non-chargeback business model. They're running either a score-based system or a decision-based algorithm without assuming any risk.

So is Riskified late to the party? Have they failed to innovate and change their model to stay competitive? Or do they know something that their competitors don’t?

There are two ways we can think about this. But first, why would these competitors switch to a non-chargeback model? The short answer is scale.

Companies can charge significantly less per transaction than their chargeback competitors by not assuming liability for decision-making errors. Forter took this path and quickly expanded into China and the United States much faster than Riskified.

The other advantage of a non-chargeback model is that it caters to the largest eCommerce revenue generators. We're talking about enough revenue where merchants can build their own in-house fraud teams. In that instance, it makes sense to choose Forter for *some* level of fraud protection because you're confident in your in-house team's ability to reduce chargebacks.

Here's why. There's no incentive for fraud prevention companies to improve their chargeback rates if they're not assuming chargeback liability.

This is where the Chargeback Guarantee model wins. It's not enough to have high approval percentages. Merchants *must* reduce chargeback rates or face *severe penalties* from the card issuers like Visa, Mastercard, etc.

Let's use an example from Air Europa to explain such consequences.

Air Europa had a juvenile eCommerce business six years ago. According to the Head of Payments and Fraud at the company, "it was one website, two guys, and no funding."

To start, the company had basic in-house fraud prevention rules (if-then statements, mostly). The basic rules prevented fraud but also declined "so many good customers." Then, a new management team came in and pushed most of the company's sales through the eCommerce platform. Enter fraud and chargebacks.

Here's how the Head of Payments and Fraud explained the situation (emphasis mine):

> *"They started fixing some basic things in the web, volume started to grow very quickly, like doubling every year. And then along came the fraud, right? So the minute fraudsters saw that they could make some business in our web. They started attacking.* ***Chargeback rates began to grow beyond 1%.***
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> *When that happened, Visa and Mastercard included the merchant into what they call it their fraud or chargeback programs, right?* ***So they first get a warning, then after 3 months, if you don't do anything, they start fining like EUR 50,000, whatever.*** *And in the next 3 months, if you don't do anything,* ***then it's 5x more, something like that. And it keeps going up.***
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> *So that's when the first fine came, is when the manager of the website, we need someone to take care of this. And yes, and that's when I started. And the first thing that I had to do was to implement Riskified to stop the fines from Visa."*

High chargeback rates are deadly for a merchant. Not only do you lose the revenue from the sale, but you also pay for the increased cost of servicing the fraud. That's all *before* Visa or Mastercard levies you with massive fines and puts you, the merchant, on a watchlist.

Left unattended, card issuers start declining *good* sales out of fear of fraudulent transactions.

A chargeback guarantee-based business model solves this problem.

This brings us to the final difference between Forter and Riskified: **Riskified's *Deco* Product.**

Deco: Riskified's Hidden Gem

According to Riskified, up to 1 in every 7 eCommerce dollars is lost to payment authorization failures or roughly $600B annually. Deco helps merchants collect revenue from payment authorization failures at the bank level.

Here's the critical part. 72% of those payment authorization failures come from *legitimate* customers. That's $432B in annual revenue missed by merchants from legitimate customers.

RSKD's Deco product is ***the first of its kind to solve this problem for merchants***. Forter does not have a comparable product. Here's how Deco works.

Banks develop patterns with their customers. They know how often they spend, where they spend, and how much they spend per transaction. Anything outside this normal distribution gets flagged.

Sometimes, the bank will outright decline a transaction because it's so far from a consumer's typical spending distribution pattern.

At the point of bank failure, Deco says, "Hey, we saw that your bank declined the transaction. Based on our data, we know you're a legitimate customer. Let us pay for the product now, and you can pay us later."

So it's a Buy Now Pay Later (BNPL) product at the point of bank transaction failure. One former RSKD Director explains it like this (emphasis mine):

> *"It's very simple. At the end of the day, the bank decided to decline a transaction. The merchant doesn't really know what the reason is. And instead of telling the end customer, you will just decline. You are telling them that hey, you were declined. do you want to pay with Deco for your transaction?*
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> *It's like credit, right? You will need to say that this customer is trustworthy and that Riskified believes that this customer will actually pay back the loan. Now it's not the free loan because the fee will come from the merchant. So without going into specific fees, but the merchant will pay a fee for this.*
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> *So let's say that it was a $1,000 order or $100 order. Riskified will cut the fee from the merchant. Riskified will also process the transaction and everything."*

Clearly, this product has value. But what's it worth? A hedge fund buddy (and fellow RSKD bull) sent me his back-of-the-envelope valuation on Deco. You can view the model here.

There are five levers/assumptions to this model:

- Global eCommerce GMV growth: 20% 2YR CAGR
- Card Network Rejections: ~10.5% of eCommerce GMV
- Deco Market Share of Rejected GMV: 7.7% by 2023
- Conversion Rates of Rejected to Deco: 17% by 2023
- Take Rates: 4%

Under these assumptions, we get ~$7.1T in global eCommerce GMV and ~$750B in Card Rejection GMV (10.5% share). Next, we assume Deco captures ~4% of the total card rejected GMV. The 4% figure mirrors RSKD's current market share in its core Chargeback Guarantee business. That gets us ~$25B in Deco-specific GMV.

Now, Deco won't convert every customer to its product, so we're assuming ~17% of those within Deco's GMV choose to have Deco pay for the product ($4.15B). Attach a 4% take rate, and you get roughly $166M in revenue from Deco alone.

Add a ~50% contribution margin (similar to Chargeback Guarantee margins), and you get ~$83M in Gross Profit. **A ~25x multiple on 2023E Gross Margin gets you a little over $2B in enterprise value. That's roughly half the current market cap today.**

I want to reiterate that this is a *very rough* sketch of Deco's potential valuation. A lot can change between take rates, conversion rates, and card network rejections that we didn't estimate.

But if Deco is worth half the current market cap in three years, what does that mean for the rest of the business and product lines?

Riskified: The Better Value Proposition For Global Customers

The only thing that matters is the merchant's decision on which product to use: Riskified or Forter. Luckily, the market is large enough for both competitors to compete profitabilty while becoming significantly larger businesses over time.

We can also assume a couple of things about the future growth of eCommerce. First, more companies will sell products/services online in 10 years than they do today. Second, most of the increase in global eCommerce will happen *outside* the United States.

Under the above assumptions, Riskified makes the most sense for global eCommerce merchants, which should provide most of the growth in eCommerce sales going forward. Merchants will sell more products to a global customer base and want guaranteed fraud protection as they test new markets and product verticals.

As more companies switch to a non-chargeback model, Riskified stands alone, offering its merchants complete protection against fraud liability. This allows merchants to focus on what they do best while outsourcing one of the most complex aspects of eCommerce to a company that's 100% dedicated to it.

It's hard to find a better value proposition for the customer than that.

