An Equity Note

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What's Inside:

- Updated thoughts on Cardlytics (CDLX) product development and Bank of America renewal
- Updated thoughts on Riskified (RSKD) regarding PSD2

Companies Mentioned:

- Riskified (RSKD)
- Cardlytics (CDLX)

MO Equity Note: Some Thoughts On Riskified (RSKD) & Cardlytics (CDLX)

Happy New Year! From all of us at MO HQ, we want to wish you a happy first day of 2022.

We are *amped* about what 2022 holds for Macro Ops and the Collective community!

This weekend, I updated my thoughts on Riskified (RSKD) and their position within PSD2 regulations. I also discuss Cardlytics' (CDLX) latest product improvements and the 600lb gorilla in the room: Bank of America contract renewal.

Let's get after it.

Riskified (RSKD): Working Through PSD2 & Notes From Call w/ Management

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

RSKD'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.

You can read our entire write-up on the company here.

The company IPO'd at a $4.4B valuation. Since then, shares have collapsed **over 70%** to ~$8/share or a $1.3B market cap. There are **real** reasons for the share price decline, which we'll discuss further.

But I do want to mention one thing. **40% of the company's market cap is in cash.** In other words, back out the cash, and you can buy RSKD's business for ~$771M.

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RSKD isn't a "no-brainer" at the current stock price. There are *real* headwinds that could negatively impact the company's long-term growth algorithm *and* total addressable market (TAM). The biggest of these headwinds is PSD2.

What is PSD2?

PSD2 is a European payments regulation that mandates the use of Two-Factor ("2FA" or "Strong Factor") Customer Authentication. Under the new rules, customers must provide two of the following authentications:

- Something they **know** (password or PIN)
- Something they **have** (mobile phone text confirmation)
- Something they **are** (Face ID or fingerprint scan)

These regulations apply to *all* online transactions over EUR 30. Importantly, PSD2 is **only for intra-European transactions**. In other words, a European merchant selling to a European customer. There are, however, nine exemptions merchants can use to bypass PSD2 regulations.

PSD2 sounds like a kill-shot for RSKD bulls (which helps explain the share price). After all, Two-Factor Authentication (like passwords or PINs) removes the need for something like RSKD. Because at that point, the risk shifts from the merchant to the issuer of the payment.

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Additionally, PSD2 adds a third option to the historically binary fraud decision of **yes (approve), no (decline),** and now **maybe (2FA).**

One fundamental question potential RSKD investors should ask is, "*what's the long-term potential damage to RSKD's TAM and customer transaction volume as a result of PSD2?*"

If PSD2 does disrupt (or eliminate) RSKD's customer value proposition, we should see the following evidence:

- Lower transaction volumes through RSKD's platform
- A steady decline in European revenue and customers

I took these questions to Noa Sella, Head of FP&A at Riskified. The following are my notes from the call.

Notes From Call w/ Noa Sella, Head of FP&A at Riskified

First, RSKD has known about PSD2 since 2010, and they've prepared their product offerings to adjust to the new reality.

For example, the company released PSD2 Optimize to help merchants navigate the consequences of PSD2. They also released ATO to combat fraud's newest trend, account takeover.

The biggest issue RSKD has seen with its customers is increased friction using PSD2 authentication. In some cases, RSKD has seen a 15-20% reduction in approvals due to such frictions. Increased friction has also slowed adoption rates across Europe. Like prior earnings calls, Noa reiterated that PSD2 headwinds *should* peak by the end of Q1 2022.

I then asked Noa about customer losses and overall transaction volume trends. Her answers surprised me. She said that though PSD2 is increasing across Europe, **RSKD has seen an *increase* In total transactions.** This makes sense since most European PSD2 merchants saw 5-20% decreases in approvals.

I'm skeptical of the above data point for a couple of reasons. One, 2FA will likely improve over time, which will reduce friction at checkout. Second, we should expect a lag in transaction volume data as customers slowly shift more transactions through PSD2 versus RSKD.

That said, one possibility increases the need for RSKD despite widespread PSD2 implementation.

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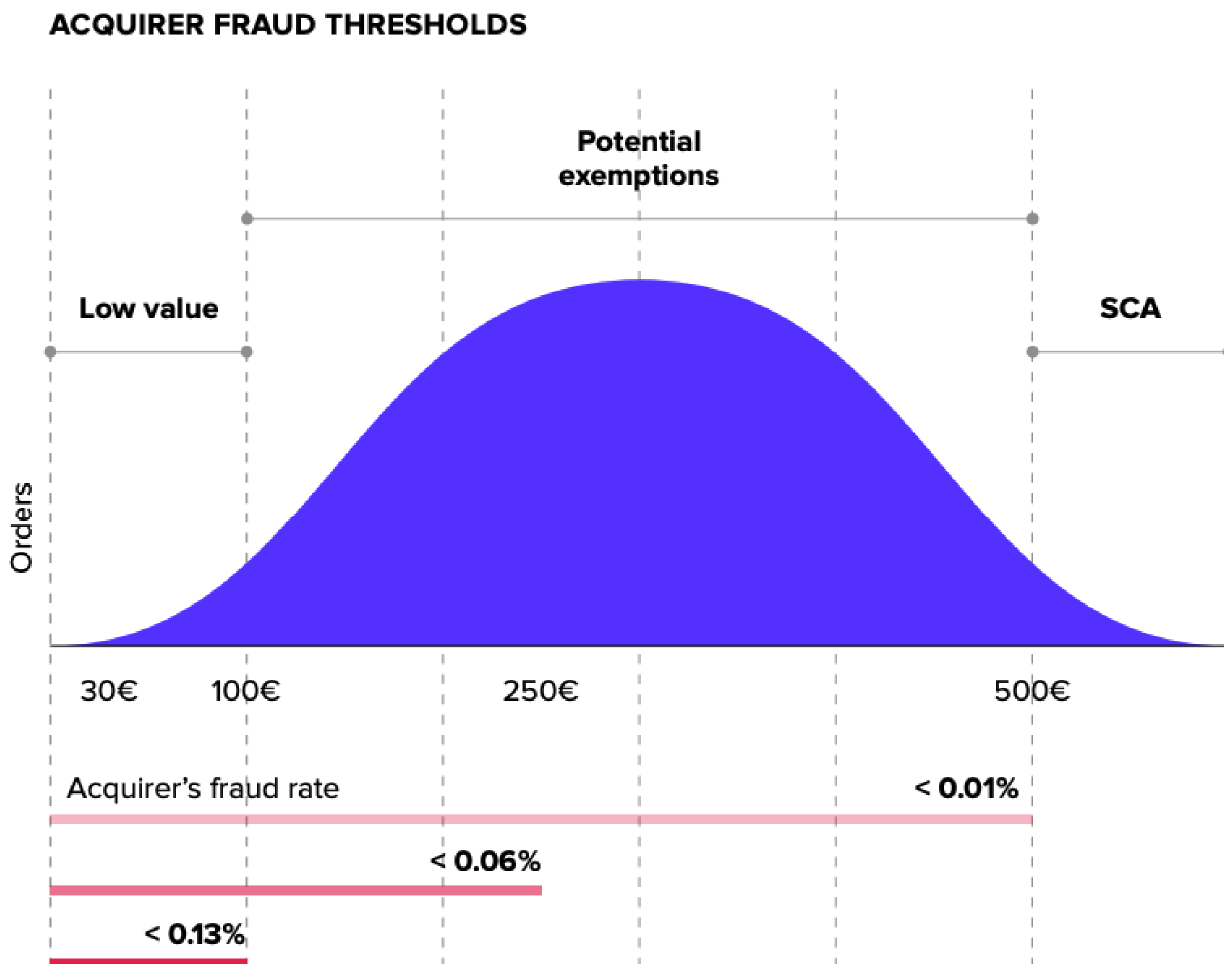
Low-Risk Exemptions

One exemption acquirers can use is called "Low Risk." Here's the definition (emphasis mine):

> *"Low risk transactions between the value of* ***€30 and €500 can go through frictionless Transaction Risk Analysis (TRA) instead of SCA****. The regulation requires that acquirers meet certain fraud thresholds in order to obtain this exemption."*

Here's the exciting part. **To keep the low-risk exemption, acquirers must maintain as low of fraud rates as possible**. Which opens the door for a sustained RSKD value proposition.

You can understand the low-risk exemption through the graph below (via RSKD):



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Maybe there's a world where RSKD lives in harmony with PSD2. A world where acquirers need RSKD to maintain various exemptions to reduce the negatives of Strong Authentication.

RSKD has time to pitch its value proposition under the new PSD2 regime. Currently, 40% of European retailers expect cart abandonment rates to grow by 21-60% in the first 12-24 months of PSD2's implementation.

We Need More Data (& Time)

We simply need more data and time to understand the effects of PSD2. The next few quarters will offer valuable insights into how merchants are using (and thinking about using) RSKD in a PSD2 world. Founder Eido Gal noted in RSKD's latest Investor Day that "*we're signing up more customers today than at any point in our company's history.*" There are likely three reasons why this is happening:

- Merchants don't fully understand PSD2 and how it impacts their business with consumers
- Merchants DO understand PSD2 and how it will impact their business yet STILL choose to partner with RSKD.
- Techniques to use psd2 to work around RSKD haven't been made available yet but will be

We'll look for confirming/disconfirming evidence for each of these above hypotheses over the next few quarters and update our assumptions accordingly. Additionally, I'm working my way through every whitepaper I can find on PSD2 and its impact on companies like RSKD. I'll report my findings in the coming weeks.

Cardlytics (CDLX): Updates on Product-Level Offers & Bank of America Renewal

On December 6, CDLX launched product-level offers to US Bank consumers. Currently, US Bank is the only banking customer using the new ad server.

Management wants to have 50% of MAUs connected to the new ad server by the end of 2022.

Why are product-level offers such a big deal? According to co-founder Lynne Laube, SKU-level offers *doubles* the company's TAM (emphasis mine):

> "*If you look at ad spend in the US, about half of all advertising spend is at the brand level, so it's Sony's, Nike's, and CPG's, and the other half is at the retail level. If you*

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> *look at our current offering today, we can't sell to any of those brands.* ***So it really does double our TAM."***

Dosh also started testing product-level rewards with Rite-Aid. Customers can now enjoy cash-back on items like Mucinex, Tylenol, and other products inside Dosh's rewards platform.

Again, it's hard to overemphasize the importance of this product update. It enhances the bank's product through better UI/UX. It improves the value proposition for advertisers with SKU-level offerings and greater brand awareness (thanks to logos).

But nobody seems to care. Everyone's focused on one thing: **Bank of America**.

Bank of America: The 600lb Gorilla In The Room

Bank of America (BofA) is the 600lb gorilla in the room. Last quarter, CDLX *had not* successfully negotiated a renewal deal with BofA (the current agreement ends 12/31/2021). Moreover, it's *rumored* that BofA is testing local-only offers with Figg, a direct competitor to CDLX.

Lynne explained, however, that the BofA deal *will* eventually close (from Q3 earnings, emphasis mine):

> *"Regardless,* ***we fully expect to reach an agreement with BofA*** *and believe this new contract will be highly beneficial to both parties."*

Unfortunately, that wasn't enough to calm investors' nerves as shares have been down ~23% since Q3 earnings.

Lynne followed her Q3 remarks with further confidence during the Raymond James Technology conference (emphasis mine):

> *"I do think it's an epic overreaction ... When we said the BofA contract wasn't going to get done by the end of the year, I think a number of investors freaked out.* ***I can confidently tell you that contract is going to get done. Confidently. It's just a matter of how much goodness do we get in there."***

Let's think about both scenarios, starting with a **non-renewal** from BofA.

Does a BofA Exit Make Logical Sense?

There are two main reasons why BofA wouldn't renew its contract with CDLX. BofA might be satisfied with Figg's offering and doesn't see a need for CDLX. Or they're unhappy with the slow pace of CDLX's product development. Both of these reasons fail the sniff test.

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First, BofA has renewed its original contract ***four times*** since partnering in 2010. Three of those past renewals went to *extending* their relationship with CDLX. Most of these contracts also come with month-to-month clauses, letting banks use CDLX during the renewal negotiations. In other words, this is standard procedure for the two parties.

Second, it doesn't make sense for BofA to cancel their renewal *now,* given CDLX's massive improvements in product and capabilities. CDLX finally provides product-level offerings, self-service platforms, and a new ad server. If BofA were leaving, you'd assume they'd wait *at least* one more year to test-run CDLX's latest offerings.

Despite the product improvement inside CDLX, there are also rumors that Figg's testing with BofA isn't going well.

Here's a snippet from Austin Swanson's blog post explaining Figg's poor results (emphasis mine):

> *Multiple people have reported that the testing is going poorly. Possible reasons for the testing of Figg going poorly include:*
>
> - *Figg's offers were low in amount (5%, compared to 10-20%+ on national brands supplied by Cardlytics), and therefore not enough of an incentive to use*
> - *Figg's offers had poor logos (in some cases only words)*
> - *Figg's offers had no images to know who they were or what they were selling (with national brands the name and logo are more recognizable)*
> - *Figg's offers were shown to anyone within a large radius (making them less relevant and known)*
> - *Figg's offers were supposedly not targeted based on purchase data (making them less relevant)*
> - *Figg's offers were mixed with national offers (making them less easy to find and likely decreasing overall engagement)*

However, these are still rumors. So take them with a grain of salt.

Finally, we don't have evidence of systemic issues with CDLX and other bank partners. For example, on October 31, Trust Bank extended its contract with CDLX for an additional three years.

We gave four specific examples of why a BofA contract cancellation doesn't make sense. But let's step back and think about BofA and CDLX from a first-principles perspective.

First-Principles Reasons Why BofA Wouldn't Switch

There are three significant reasons why BofA will likely renew with CDLX from a first-principles standpoint:

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- **Banks would prefer to use one supplier**
- **CDLX already has trust with banking partners**
- **CDLX provides more benefits than any competitor, given its scaled network effects**

Banks are slow-moving beasts. There are droves of red tape and KYC compliance required to do anything.

It wouldn't make sense for banks to increase the complexity of card-linked offers by adding new suppliers. Especially when the existing one (CDLX) continues to add new features and improve its value proposition.

Then there's the data security risk.

CDLX has worked with BofA for twelve years without a single data breach. That accrued trust gives CDLX a significant advantage over a competitor like Figg. Suppose Figg's product *is* better than CDLX. What are the odds a bank risks a potential data breach by switching providers?

Here's how CDLX's former Chief Revenue Officer explained the data security advantage (emphasis mine):

> *"The reason that this space is so protected is that the #1 rule with these banks is they're only going to let somebody come in and run a program like this. Let's say, the LRCC, the legal risk and compliance group, absolutely blesses in trust. Because at the end of the day, none of what Cardlytics does in terms of rev share back to the bank means squat if there's a data breach.*
>
> *And Cardlytics has been running this program now for 12 years, with zero data breaches, zero issues on any of the transactions and any of the data that they run.* ***So your challenge coming in and saying, I would like to compete with Cardlytics is you have to be able to prove that you can run as tight a ship as Cardlytics does relative to the protection of the data because that is #1 issue."***

The final reason BofA wouldn't switch is CDLX's scaled network effect advantage over the competition. CDLX has 160M+ MAUs on its platform and sees ~1 out of every 2 credit card transactions in the US. No competitor comes close to that type of reach.

Lynne explained the company's data advantage on the Q3 earnings call (emphasis mine):

> *"On the competition question,* ***there's really no one out there still in the U.S. and in the U.K., to the best of my knowledge, that is competing with us in terms of getting access to bank's data and bank's digital channels*** *to publish targeted advertising content and content that gives you the ability to fully close the loop."*

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Think about the decision from an advertiser's perspective, like Home Depot. Which provider would you choose? The one with 160M MAUs with incredibly detailed insights into how consumers spend at your store? Or the one with a fraction of the MAUs and no visibility into card-linked transaction data?

One final point on CDLX versus its competition. Historically, Figg has touted its local offer features as an advantage over CDLX. That should change as CDLX rolls out its self-service platform for SMBs and SKU-level product offers.

Share Price Overreaction Creates Opportunity For Re-Entry

With the stock down 23% since Q3 earnings, the company now trades at an unassuming $2.23B market cap (or 7x NTM sales). As we mentioned above, there's a high probability that CDLX and BofA will close on the contract renewal *sometime early* next year. Not to mention the product-level offers with US Bank, the new ad server, and a new self-service platform. There's *a lot* to be excited about over the coming year.

It's not crazy to think that by next year CDLX could:

- **Move all advertisers to its new ad server**
- **Roll-out SKU-level offers across all banking partners**
- **Capture significant revenue from ad agencies with its self-service platform**
- **Command a more substantial share of advertisers' marketing budgets**

According to TIKR, CDLX expects to grow top-line revenues at a 37% CAGR from $253M in 2021 to $892M by 2025.

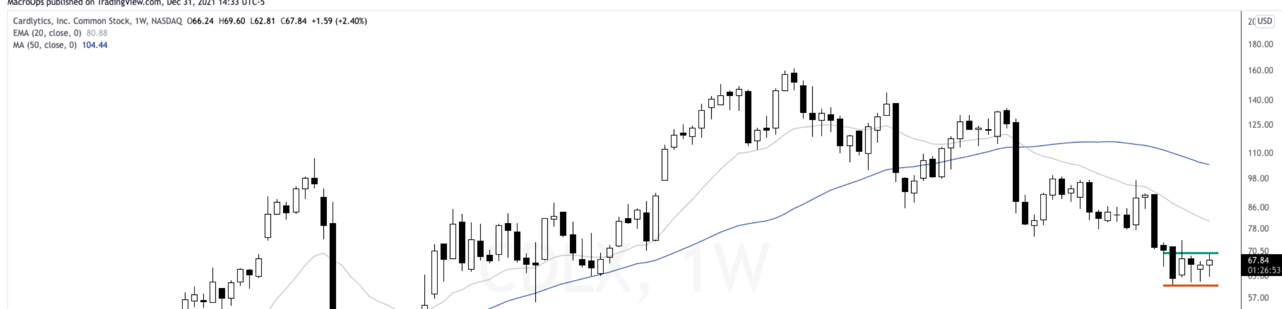
That means we can buy CDLX today for ~2.5x 2025E revenues.

Over time, CDLX should leverage its fixed cost base to generate double-digit EBIT margins and strong free cash flow. 2.5x sales is laughably cheap should CDLX remotely hit those revenues and EBIT estimates.

Here's our re-entry plan.

The stock currently respects long-term support around $62-$63/share, providing an excellent stop-loss position. Its current share price of ~$68 allows us to get considerable exposure with little actual risk.

Next week, we'll purchase a starter position as the stock remains below its 50MA while in a sustained downtrend. However, we'll aggressively add to our starter position should the stock move in our favor.



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