

An Equity Note

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What's Inside:

- *Reviewing SQ Q2 Earnings Report*
- *Updating Our Priors on LT Bull Thesis*
- *CashApp New Product Releases*
- *Afterpay to replace credit cards?*
- *Portfolio Moves*

Companies Mentioned:

- *Square (SQ)*
- *Cardlytics (CDLX)*

Equity Note: Square (SQ) Earnings Recap & Updating Priors

We're working through the Q2 Earnings Season. This weekend, we dissect Block's (SQ) latest earnings report, update our priors, and assess our probability of SQ's long-term success.

The company continues to execute on its long-term strategy of providing more substantial financial access to millions of Americans. It's doing so with simple (yet clean) technology and a frictionless customer experience.

We also highlight a few key product developments that could generate massive revenues in the coming years.

Finally, we guess how SQ might use Afterpay to replace credit cards for Gen Z consumers.

Before we dive in, I want to say how excited I am to have Alex back in the saddle with me. We've managed not to kill financial markets on his leave. That's worth celebrating, right?

Alright, let's get after it.

Block, Inc. (SQ): Bull Thesis Keeps Chugging Along

Block (SQ) provides merchant seller services through its "Square" product to over 2 million businesses. Popular products include Square Invoicing, Payroll, Square for Restaurants and Square Capital.

The company also serves 47 million consumers through CashApp. CashApp allows users to instantly send money to friends and family, invest in stocks and bitcoin, save money through CashApp *Boost* discounts at popular retailers, and receive direct deposit paychecks.

SQ is building one of the most exciting business ecosystems globally by connecting merchant sellers with Cash App consumers. I called it *Ecosystem Connection* in my SQ write-up (read [here](#)).

We can think of this Ecosystem Connection as the heart of global commerce. I expanded on this idea in the write-up (emphasis mine):

*“SQ’s End Game [Ecosystem Connection] resembles the human heart in many ways. The heart takes blood in your body and circulates it to areas that need it for repair, contraction, or other functions. Commerce is a lot like the human heart, too. **Consumers take dollars and pay businesses for goods or services. Companies then use those dollars to pay employees, buy supplies, and invest in growing their operations. Employees then take those dollars and the cycle repeats.**”*

Here’s my estimate of SQ’s vision for the world ...

Square merchants maintain checking and savings accounts and use Square Payroll to pay employees.

Employees receive direct deposit via Cash App, which they use to spend on goods/services at other Square merchant establishments.

Cash App then offers discounts to users that spend at Square merchants or other retailers through Boost, further incentivizing Ecosystem-Connection driven commerce.

The company continued making strides on our *Variant Perception* during Q2. Let’s dive in.

SQ Latest Earnings

The company reported Q2 earnings last week. Here are the highlights:

- Revenue decreased by 6% YoY to \$4.4B (driven by a decrease in Bitcoin revenues)
- Gross Profit increased by 29% for Square & CashApp
- Generated \$187M in Adjusted EBITDA and a \$208M loss
- Total GVP increased by 23% to \$52.5B
- 13% of Square’s Gross Profit is outside the U.S.

SQ improved on every long-term KPI we use to judge our thesis. Let’s break down these improvements, starting with Square.

Square: More Transactions, More Services, & Greater Value

Square generated \$1.36B of transaction-based revenue in Q2, up 22% YoY and 21% on a 3YR CAGR basis. In other words, more people transact through Square POS systems than last quarter.

Transaction revenue is a low-margin business. The company generates high-margin revenue through subscription software like Payroll, Banking, Instant Transfer, and Square Loans. These products grew like gangbusters.

Square generated \$318M in subscription and service revenue during Q2 2022, an increase of 110% YoY and 53% on a 3YR CAGR basis.

SQUARE SUBSCRIPTION AND SERVICES-BASED REVENUE EX-PPP AND EX-BNPL PLATFORM

	2Q19	2Q20	2Q21	2Q22
Square subscription and services-based revenue	\$90M	\$75M	\$151M	\$318M
PPP loan forgiveness revenue	\$0M	\$0M	\$15M	\$9M
Square subscription and services-based revenue excluding PPP forgiveness	\$90M	\$75M	\$136M	\$309M
BNPL platform subscription and services-based revenue allocated to Square	\$0M	\$0M	\$0M	\$104M
Square subscription and services-based revenue excluding PPP forgiveness and excluding contributions from BNPL platform	\$90M	\$75M	\$136M	\$205M

Then there's Square Loans, which grew 30% YoY as the company originated ~122K loans for \$1.01B.

Here's the wild part. **Square has a negative CAC on its loan origination business.** Why? Square customers *already use* multiple products like Payroll or POS.

Moreover, it costs Square almost nothing to originate the loans as the company leverages AI/ML to analyze each company's current/historical revenue trends.

Recent Tegus calls with SQ experts revealed that SQ is *conservative* with its Loans product. According to industry experts, the company could sustain *much higher* loss ratios than its current percentage. This makes sense for two reasons.

First, Square Loans has access to its business's current revenue trends, providing real-time insights into a company's ability to repay a loan.

Second, Square Loans repayment is linked to a business's bank account. So if the business can't meet the 60-day minimum payment requirement through card transactions, Square takes the difference from the bank account. It's effortless.

These reasons make me believe that Square Loans is a sneaky product that could 5-10x over the next few years.

Finally, Square announced during the quarter that merchants can now accept Afterpay as a payment method. In other words, Square merchants receive full price for their goods/services, and consumers pay in 4 bi-weekly installments.

More on this later. Next, let's dive into CashApp, SQ's growth engine.

CashApp: Building A Better Commerce Experience

CashApp generated \$2.62B in revenue (21% growth ex-bitcoin revenue) and \$705M in gross profit (29% growth) during the quarter. The app boasted 47M users at the end of the quarter.

Inflows and **products** are CashApp's two key growth drivers. More money in the app allows consumers (or "actives") to increase the number of products they use. A higher balance incentivizes actives to use CashApp for routine purchases, to buy bitcoin, or send money to friends and family.

We know consumers can send their direct deposit checks to CashApp, which increases inflows. And we know CashApp [Boost](#) allows users to receive discounts on items from retailers like Target or 10% in Bitcoin.

CashApp's *Boost* feature could become a *serious* revenue/profit driver over the next few years. It's basically Cardlytics for CashApp. And there are significant benefits to *Boost* that CDLX can't match.

For example, CDLX is at the mercy of bank innovation and product approval. Since *Boost* is built *by* CashApp *for* CashApp, they can move as quickly as they want.

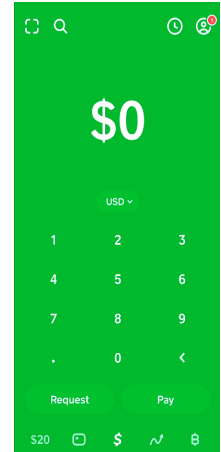
This advantage should increase as SQ signs more retailers at a faster rate. In fact, [the company's hiring](#) a Product Marketing Manager for **Ads and Incentives**.

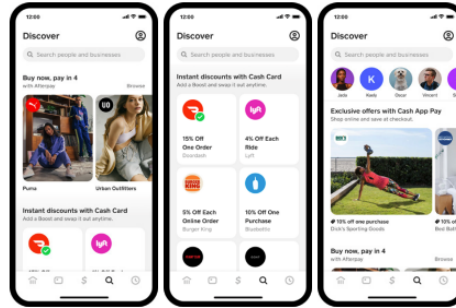
SQ released three new product features during the quarter.

First, CashApp released a new *Discover* Tab. According to the company's earnings report (emphasis mine):

*"The Discover Tab will make our commerce offerings — including Cash App Pay, Afterpay, and Boost — more prominent, and **provide a more cohesive customer experience to help customers find things they care about, including friends and businesses.**"*

The *Discover* tab is a necessary step in **retaining more of the commerce transactions on CashApp**.





No association with any real persons is intended or should be inferred. Screens may be approximations as they are also provided for demonstration purposes.

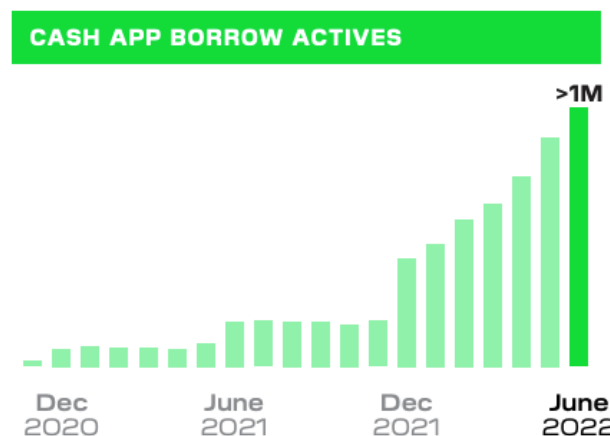
For example, instead of buying Puma shoes through Puma.com, a CashApp user can buy them without ever leaving the App. Consumers can also purchase products through CashApp and seamlessly pay for them with Afterpay in 4 easy installments. Again, all without leaving the app.

Then there's *Round Ups*, CashApp's second product release of the quarter. *Round Ups* allow consumers to (you guessed it) round up their purchases and invest the change into their favorite stock.

Round Ups isn't a product innovation. Ashton Kutcher-backed companies have done this before. The difference is it's *one more thing* to keep people spending on the app and eventually bring in more inflows.

I've experienced an increase in CashApp use since *Round Ups* allowed me to invest my spare change in SQ stock. No lie!

The final product release of the quarter was CashApp Borrow. CashApp Borrow is basically Square Loans for CashApp consumers. Actives can receive up to \$600 in short-term loans that they pay back via scheduled installments or as a percentage of bi-weekly inflows. CashApp had 1M+ monthly actives using *Borrow* as of June 2022 (see below).



CashApp Borrow customers are some of the most active accounts on the app. According to Square, these customers bring in ~4x the inflows as peer-to-peer actives.

More products → more inflows → more products → more inflows

The above flywheel translates to more substantial gross (and net) profits as more consumers bring more money into CashApp and use more services than ever before.

Finally, let's discuss Afterpay and its role in bridging the gap between Square's Merchant and CashApp consumer businesses.

Afterpay: Bridging Square's Disparate Economies

Unless you're paying for overpriced coffee at the local Square-powered Barista with your CashApp debit card, Square's ecosystems remain primarily unconnected.

Enter Afterpay.

Afterpay is Square's bridge to connect its Square Merchant and CashApp consumer ecosystems.

The hypothesis is simple. It's much harder to switch every merchant's payment infrastructure than to switch consumers from using credit cards to Afterpay's 4-payment installment product (which is still *very* difficult!).

The more retailers that accept Afterpay, the easier it is for consumers to choose Afterpay. And the easier it is to select Afterpay, the more consumers will adopt Afterpay as a payment method.

Suddenly, you can imagine a world where Square – through Afterpay – has its Dorsey-like tentacles touching **billions** of transactions.

We can use Afterpay as the Canary in the Coal Mine to track SQ's Ecosystem Connection progress.

Concluding Thoughts

Our long-term Variant Perception remains intact. SQ reinforced its competitive advantages by providing greater value to its Merchant and Consumer businesses.

Merchants love Square's software and service products like Square Payroll, Banking, Instant Transfers, and Square Loans. CashApp's new features like *Round Ups*, *Boost*, and *CashApp Borrow* incentivize consumers to send more inflows and transact through the app more than ever.

In short, we're thrilled to own SQ at <3x NTM sales and look forward to buying more soon.

Portfolio Moves

Buys

- **EXITED** Copper (HGU2022) Futures Short

Sells

- **EXITED** 1stDibs (DIBS) Long
- **EXITED** Long Bonds (ZBU2022)
- **SHORTED** GBP/AUD