Afterpay :

The New Way to Pay

University of Sydney Business School
Case Competition 2019

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Dear all,

In 2014, our founders Nick Molnar and Anthony Eisen identified a shift in payment behaviour amongst millennial shoppers: an aversion to credit and a preference for debit cards. Motivated to cater to this generational shift, Afterpay was born.

Today, Afterpay provides a simple service – buy something, take it home today and repay it over 8 weeks. In the space of 4 years, we have surged to popularity and have become a lifestyle for many millennials. As Molnar notes, "Our customers love that there's no catch – they use it as a budgeting tool, not as a line of credit."

Having established ourselves as a new way to pay in Australia and New Zealand, our mission is to build a foothold globally in our newer markets in the UK and US. However, there are competitive and regulatory challenges that come with growth, as well as a need to seek new opportunities.

How can Afterpay better cater to its stakeholders globally, and meet its 3 governing pillars to 'Grow', 'Perform' and 'Innovate'? What should Afterpay do next, and how?

With other buy-now, pay-later services starting to emerge, Afterpay cannot be complacent and must continually innovate to defend its lead. Should we expand our services from a predominantly retail market? Does it make sense for this surging fintech to move into bigger and more complex transactions to break free of the millennial stereotype? Or should we explore changing our repayment model to enlarge the addressable market?

To guide you, we have provided some information regarding our history, the industry, and our customers.

We look forward to hearing your ideas.

Kind regards,
The Afterpay Team

Business Overview

The Before and After: History of Afterpay

When the Global Financial Crisis hit the world a decade ago, it was a recession that changed consumer behaviour forever. Referring to the recession as a 'milestone' and a 'generational shift', Nick Molnar recognised that there was a huge swing amongst millennials to spend money on debit cards, not credit cards. In 2014, Molnar and Antony Eisen launched Afterpay as a new way to pay, disrupting the "buy now pay later" (BNPL) and fintech scene.

With its initial success, Afterpay became a publicly listed company, floating 25 million shares on the ASX in April 2016 at AUD$1 per share (ASX: AFY). As Executive Chairman, Eisen vowed confidence in Afterpay's capacity to "support a strong growth trajectory". Investors appeared to reflect this sentiment, as Afterpay's share price rose to AUD$1.25 per share by day's end, and have grown twenty-fold to present day.

One year following its initial public offering, Afterpay successfully merged with Touchcorp to form Afterpay Touch Group (ASX: APT). Prior to the announcement, it was well known that Afterpay and Touchcorp enjoyed a close and productive relationship. The merger was seen as a 'natural evolution' of their relationship, as it leveraged Afterpay's growing retail network and Touchcorp's competencies in payment technology innovation.

Equipped with both technological and retail capabilities, Afterpay continued to grow within the Australian scene and set its vision on international markets. Afterpay successfully launched in the US mid-May 2018, and soon after launched in the UK under the Clearpay brand in June 2019.

To date, customer and merchant acquisition has been strong, with Afterpay now boasting over 2 million customers and 6,500 merchants in the US, including leading brands such as Urban Outfitters, Levi's and Ray-Ban. Despite fierce competition, Afterpay has generated circa AUD$1.7 billion in annual sales, after only 13 months of operating in the US In comparison, it took Afterpay three years to generate those sales figures in Australia, indicating the swift pace of growth in the US market.

As for the UK, Clearpay clocked up more than 200,000 active customers in its first 15 weeks since launch — ahead of the US over the same period. The UK is the third largest e-commerce market in the world after China and the US, and is 2.6 times bigger than Australia's, representing a sizeable market for Afterpay to address.

afterpay

Afterpay Today: How does Afterpay work?

Afterpay allows its customers to buy a product now and pay later through four equal repayments over a maximum period of 56 days without fees or interest. The idea is similar to the old lay-by system, except Afterpay customers receive the product up front without needing to pay the full amount at the time of purchase.

To sign up to Afterpay, customers simply fill a form supplying their name, address, date of birth, email address, mobile and debit card details, and an approval decision will be made within seconds.

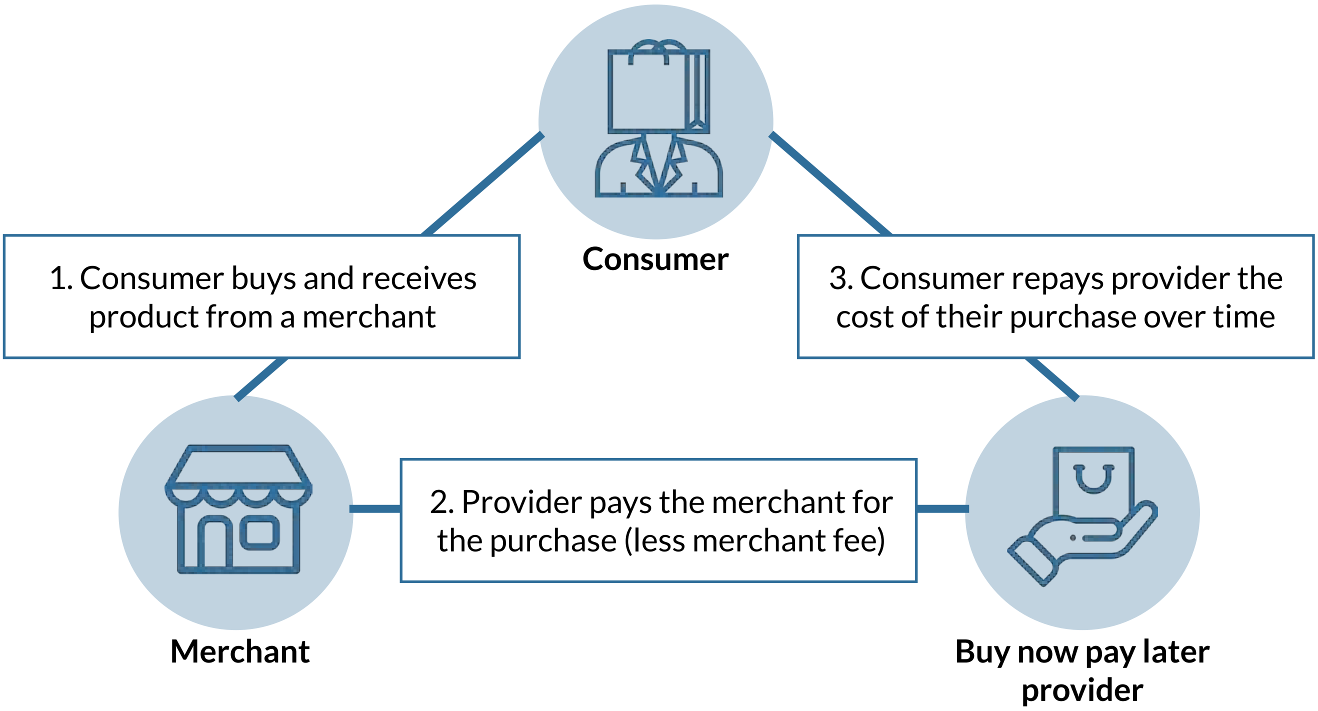


Figure 1: Afterpay's Buy Now Pay Later System. Source: ASIC, REPORT 600, Review of buy now pay later arrangements, November 2018)

In order to prevent irresponsible spending, all individual orders placed through Afterpay undergo an approval process. Afterpay does not undertake credit score checks like traditional credit providers, and instead has its own algorithms to conduct approvals.

- Firstly, Afterpay is only available to adults over 18.
- Users must have at least 25% of the purchase price present in the nominated bank account at the time of purchase.
- Afterpay also has discretion to decline based on its own assessment of risk depending on repayment history and the product type. Afterpay declines an estimated 20-30% of orders which are deemed too risky.
- All customers start on a low initial AUD$500 allowance, with limits only increasing after proving a positive repayment history over the course of six weeks (up to a maximum of $2,000).
- If a payment is missed, then no further orders can be placed with Afterpay until the account is settled.

Late fees apply for customers that do not make their repayments on time, which are capped at 25% of the item price or AUD$68 (whichever is less). During the ASIC review of BNPL providers, there were concerns that late fees were becoming an increasing source of funds for Afterpay (Figure 2). This came after late fees percentage contribution to annual pro forma revenue reached 24.6% of revenue, up from only 16.25% in 2016. However, Afterpay has reported a reduction to 18.7% of revenue in FY2019 as a result of vigilant responsible spending processes and capping late fees.

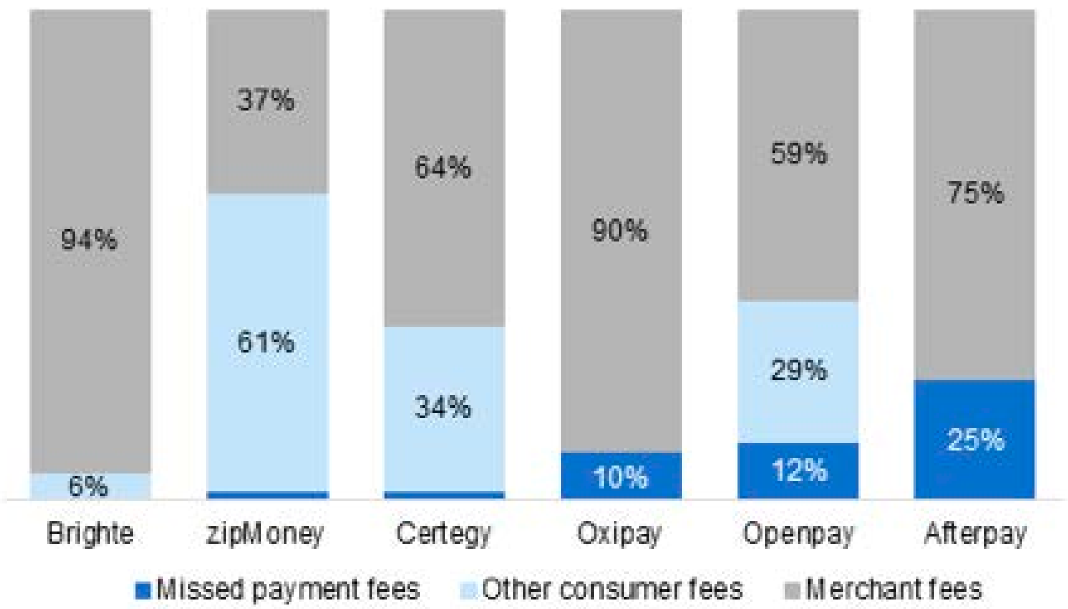
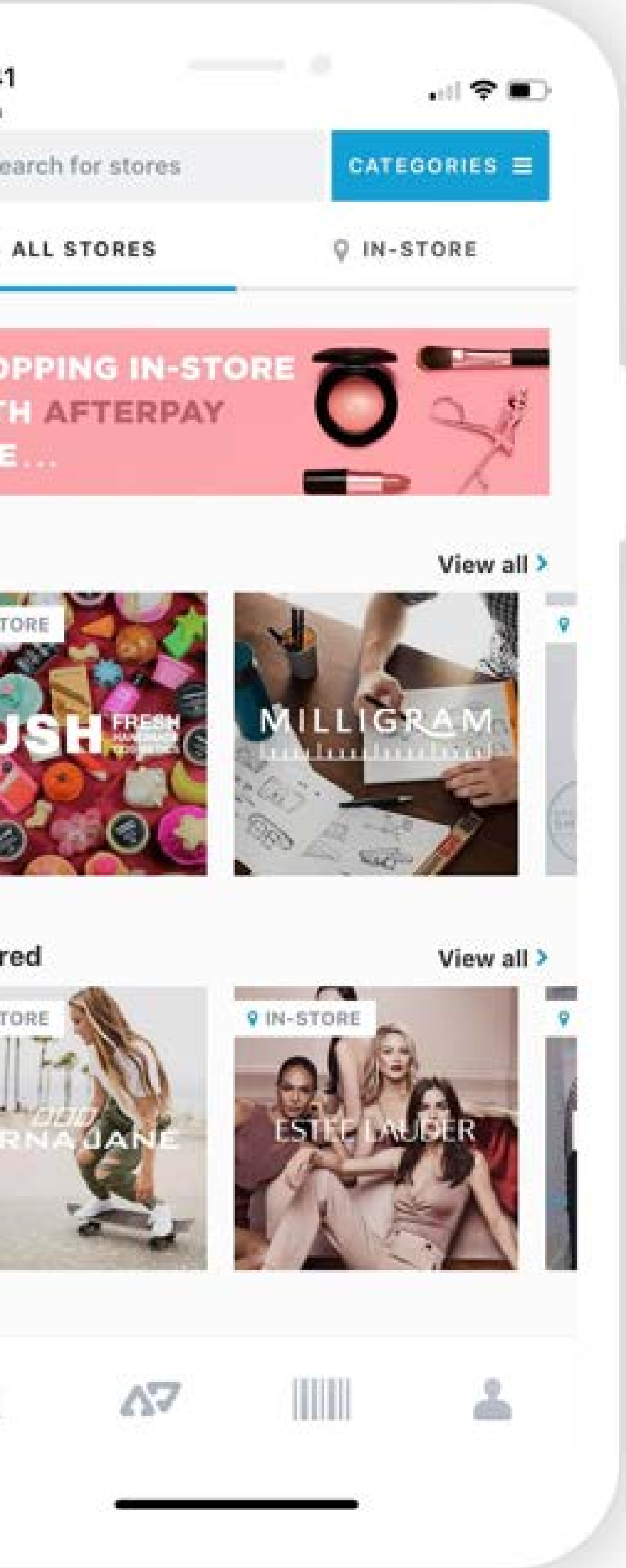


Figure 2: Revenue earned by BNPL Providers in Australia. Source: ASIC, REPORT 600, Review of buy now pay later arrangements, November 2018)

On the merchant side, Afterpay will settle the full amount of the purchase with the merchants upfront. However, a flat $0.30 fee and a commission rate fee of 3.92% on average is charged per transaction.



Afterpay App

In 2017, Afterpay introduced a mobile app which became #1 most downloaded on the App Store within 48 hours of launching. Primarily introduced to facilitate in-store purchases, the app provides a user-friendly interface to shop and manage payments (Exhibit 4). Customers can explore the shop directory of Afterpay merchants, and the app provides geographical locations as well as embedded links to the merchant's own website. Customers can also view all their orders, payments due and order history, which Afterpay markets as a budgeting tool. Additionally, the app provides access to exclusive offers within the app or via push notifications, and has Touch ID and pin-code protection at sign-in.

To use Afterpay in-store, the user taps on the barcode icon which generates a barcode. With it, the consumer simply brings the item to the counter as they normally would and the Afterpay barcode will be scanned as payment. Each generated barcode is valid for 10 minutes.

In 2019, Afterpay App recorded 4.1m downloads globally.

Afterpay Culture

With the proliferation of the Afterpay brand spanning across many new geographies and consumers, it is critical for Afterpay to stay true to its culture and mission. The fundamental idea behind Afterpay is to make purchasing feel great for a global customer base. As put by Molnar:

"…the simplicity and transparency of Afterpay and the fact we're about shifting the power back to the customer resonates with millennials..."

Customers are at the heart of Afterpay. It is marketed as a way to empower customers by allowing them to spend responsibly and stay in control of their finances through four fundamental principles:

1. Take it slow – Afterpay believes its customers should only spend what they can afford to pay back. To ensure this, Afterpay takes the time to understand their customers before allowing them to spend more through a real-time Repayment Capability check to determine spending capacity and a customer's ability to repay on time.

2. Keep Afterpay Free – Afterpay describes its business model of charging merchants as its 'northern star' and promises to never charge interest or other fees as long as customers repay on time.

3. Late payments are bad business – Afterpay have inbuilt processes seeking to minimise late payments. For example, this involves sending phone notifications in the lead up to payment and alerts if a payment has failed to process.

4. The circle of happiness – Afterpay promises a commitment to keeping customers happy, as Afterpay is anchored to the idea that growth is driven by happy customers returning and recommending their friends. They strive to achieve this through transparency underpinned by the simplicity of their product and the absence of hidden fees which Afterpay considers dishonest.

Afterpay has also cemented its position as an online sale favourite, through its AfterYay event that commenced in 2018. AfterYay is a massive two-day sale where Afterpay's merchants, both online and in-store, offer discounts up to 60% off to all customers, whether or not they are an Afterpay customer. Over 130 retailers participated in the inaugural 2018 AfterYay event, breaking retail records with AUD$15 million of sales processed - during the first hour of the sale, there were 1.5 orders processed per second.

1. Take it slow

2. Keep Afterpay free

3. Late payments are bad business

4. The circle of happiness

Customer Overview

Afterpay Users: The Millennial Wave

Once upon a time, the only way to shop was to walk through the doors of a brick-and-mortar store and make the purchase inside. Now, we can simply pick up a smartphone and speak to it.

Millennials are the first generation of 'digital natives' – those born into a world of technology. In this environment, it has enabled 7 out of 10 millennials to make purchases without even setting foot into a store. Using this growth in e-commerce, Afterpay was able to skyrocket in popularity with the millennial market. However, they have since expanded the Afterpay offering to brick and mortar store purchases, which account for approximately 20% of Afterpay's revenue.

In 2017, it had 1.5 million active customers, which grew to 2.3 million customers in 2018. Today, Afterpay has 5.2 million active customers worldwide at a growth rate of 12,000 new customers a day. The millennial market has significant growth prospects - making up 27% of the entire global population by 2020, millennials will have the highest spending power almost USD$15 trillion worldwide.

What about the BNPL platform attracts these consumers? One factor is that millennials are a generation that is more willing to spend money on comfort and convenience – almost using money as an 'emotional tool'. A BNPL service hits home on this trait – allowing shoppers to receive an item and enjoy the instant burst of dopamine without having yet to yet bear the psychological pain of paying for it. Secondly, Afterpay has also suggested that BNPL services allow users to meet their immediate purchasing needs without worrying about how to manage cashflows before payday.

Figure 3: Triggers consumers believe sparked their engagement with buy-now-pay-later services

- *62% Consumers used BNPL for the first time they made an online purchase*
- *28% influenced through word of mouth*
- *24% through advertising*
- *14% through suggestion by staff member*
- *14% seeing a poster or advertising in a retail store*

Afterpay prides itself on a net promoter score of >80, which is the willingness of customers to recommend a company's products or services to others. In 2016, Afterpay customers launched viral social media campaigns and Facebook groups where they asked their favourite retailers to sign onto the Afterpay platform, reflecting its deep popularity.

86% of first-time users believed that they would use Afterpay again – underpinned by 4 main motivations:

1. **Access to higher value purchases –** most users agreed that the service allowed purchases of more expensive items and higher spending.
2. **Access to time-sensitive purchases –** some users stated that BNPL services allowed them to take advantages of 'sales' or 'limited offers' from merchants where they couldn't meet the upfront cost of the purchase. A smaller minority used the service for unexpected expenses.
3. **Convenience and ease of use –** 81% of users believed that BNPL is an easier and simpler way to purchase items, with a very short sign-up process.
4. **Flexibility and choice –** Many consumers stated that they actively compared their payment options and concluded that BNPL arrangements were the more cost-effective versus other credit products. 65% of users agreed that the consequences of missing a repayment are less risky compared to other payment options.

As consumer uptake increases and spending behaviours change, regulators begin to scrutinise the dangers. ASIC's inquiries reveal that approximately 55% of users spend more using BNPL options (Figure 4). Further, it has also enabled a destructive form of spending, where 23% of users made repayments with a credit card – further exposing them to interest charges. As Afterpay is not registered as a credit provider, regulators are beginning to assess how BNPL users manage both credit and BNPL facilities (Figure 5). Whilst Afterpay is adamant it operates as a budgeting tool that is not comparable to traditional credit lenders, ASIC and industry professionals are not yet convinced.

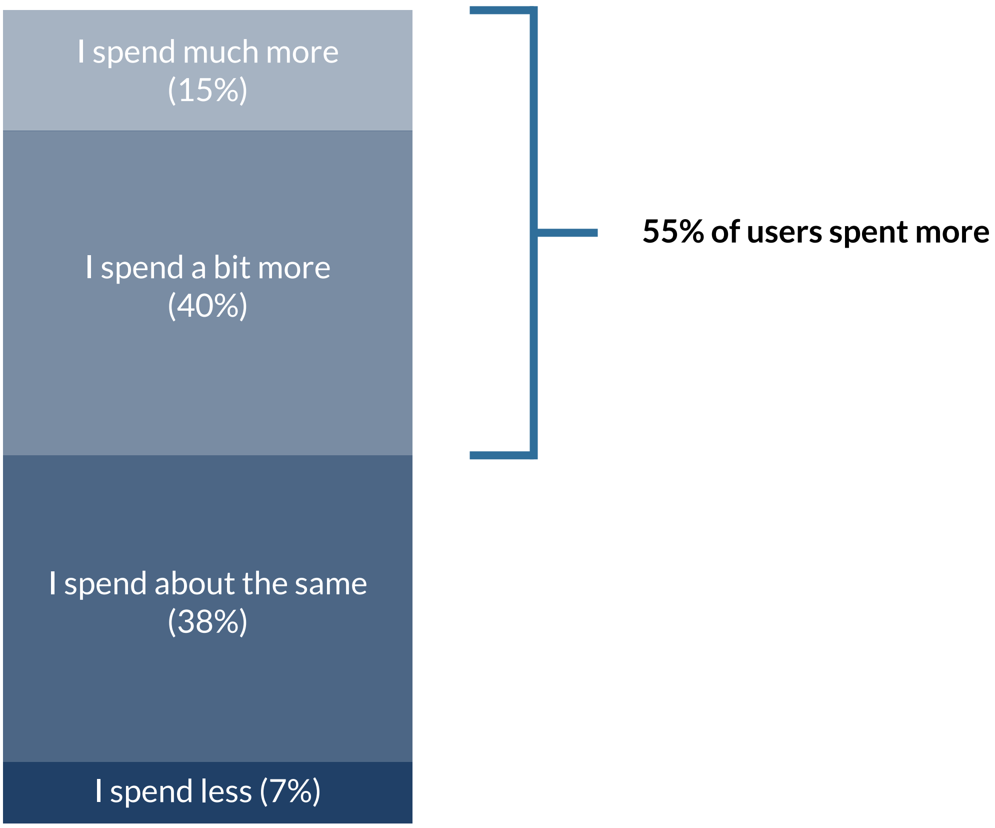


Figure 4: Spending changes for customers using BNPL

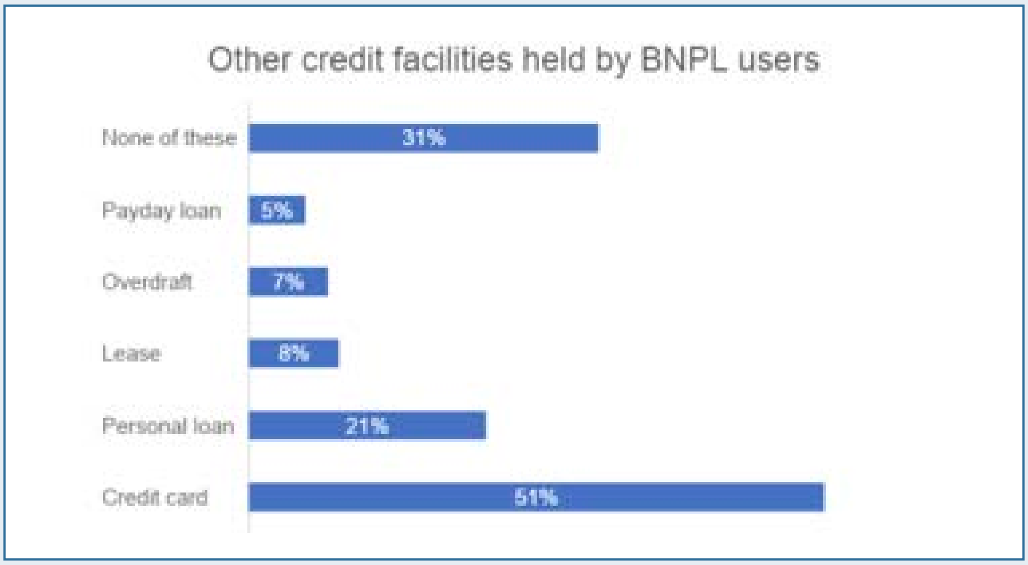


Figure 5: Other credit facilities held by BNPL users in Australia. Source: ASIC 6000 Report.

Afterpay maintains that its users are, on balance, responsible and 'sticky'. 95% of customers are returning customers, and the frequency of purchases rise with time (Figure 6). Despite industry concerns regarding the increase in debt for customers using BNPL services, Afterpay has reported an average repayment cycle of 30 days – this means that, on average, customers are repaying outstanding balances 4 weeks earlier than the 8-week maximum. However, it is still unclear whether both these trends are sustainable, given Afterpay's short lifetime. Nevertheless, Afterpay's ability to track, analyse and interpret user data may provide key opportunities for the business.

Figure 6: Trend in customer purchasing frequency over time

Moving Beyond Millennial Origins

Although research indicates that 60% of buy-now-pay-later users in Australia are aged between 18 to 34 (Figure 7), Afterpay has since expanded its demographics to capture more mature shoppers.

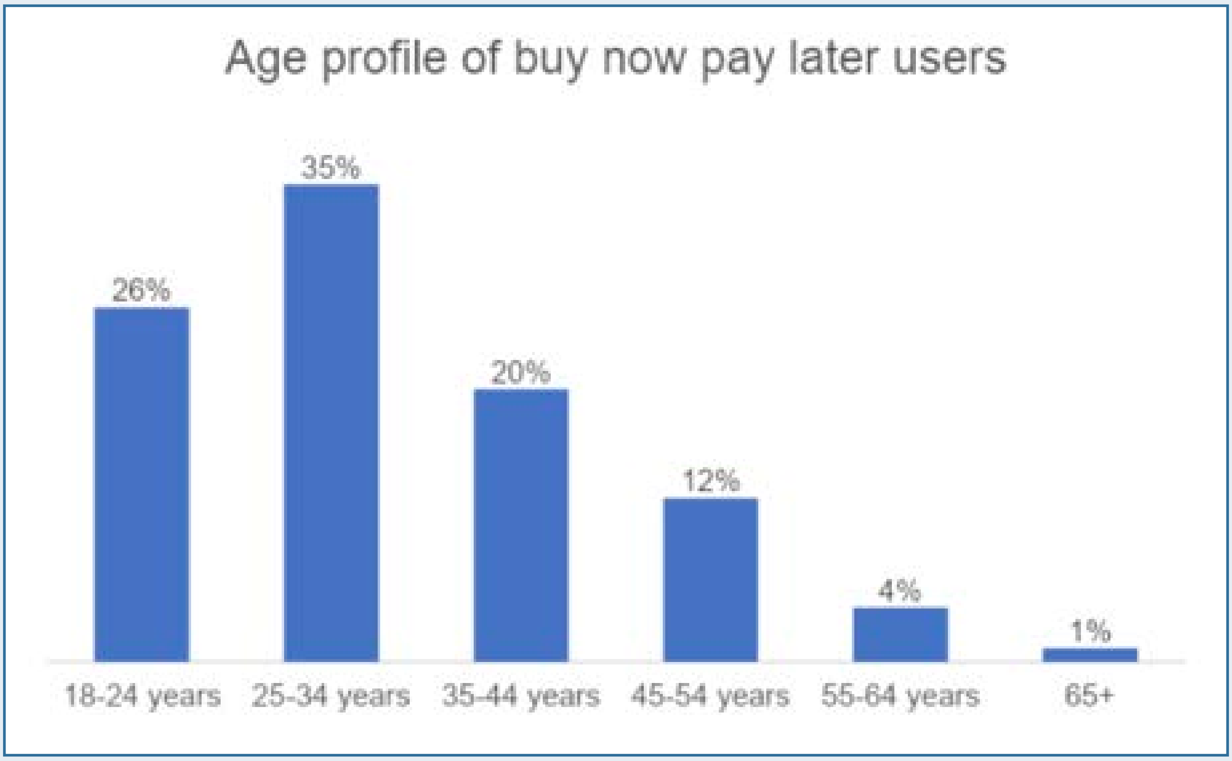


Figure 7: Age Profile of Buy Now Pay Later Users in Australia. Source: ASIC Report 600.

Afterpay has primarily expanded its customer base demographic diversifying into new , targeted verticals beyond its initial fashion and retail base – this includes healthcare, travel, concert ticketing and flights. The recent partnership with traditional retail giant David Jones also cements Afterpay's expanding customer focus, although it remains to be seen whether their unique proposition will resonate as deeply with these new users.

Afterpay Merchants

Merchants are another cornerstone to the Afterpay ecosystem. Afterpay provides several unique value propositions that attract merchants to join the platform, despite the existence of merchant fees that cut into per unit revenue.

Afterpay assumes all bad debts and credit risk by settling accounts immediately. Conversion rates and incremental spend are also increased, as Afterpay supplements funds to customers that would have otherwise not made a purchase. By significantly lowering upfront spend for a customer in each purchase, crucial pain points are removed and therefore Afterpay generates increased sales for the merchant over their lifetime. Finally, as Afterpay continues to expand globally, initiatives such as Afterpay's Global Mentorship program enables the merchant partner community to forge networks, creating opportunities for recognition, development and collaboration.

Whilst Afterpay signed on 6,000 merchants in 2018, this has skyrocketed to 35,300 retail merchants globally in 2019. With the expansion into the UK and the US, this figure is increasing by 750-1,000 merchants per month. However, with Afterpay's purchasing limit capped at $2,000, retailers in higher-value categories cannot be reached. Perhaps this repayment limit will leave Afterpay susceptible to new competitors who can better cater for higher-value retailers.

Afterpay started with a focus on partnering with online retailers of apparel and jewellery, and now holds at least 25% of the online apparel market. However, it has been rapidly expanding into new verticals, reaching more diverse retail markets (Figure 8). Now, Afterpay can be used to pay for items such as dental care, plane tickets and automobile parts - truly cementing its status as a new way to pay. Afterpay has also successfully transitioned into the traditional brick-and-mortar stores, with 20% of sales coming from in-store purchases. It is not uncommon to walk through a shopping centre and see the Afterpay sticker at the front of a merchant's store.

Afterpay also has a diverse portfolio of merchants types, which are internally labelled as:

1. Small to medium enterprises (SMEs): these are businesses with relatively niche offerings or smaller footprints, and are usually inbound enquiries. They account for the majority of Afterpay's merchant list in Australia.

2. Mid-market: these are usually business chains or retail groups such as Jetstar which bring in substantial customer bases, but are not as large as enterprise businesses. These can range from inbound enquiries or businesses which are actively sought by Afterpay sales teams.

3. Enterprise: these are industry giants such as Myer, Urban Outfitters and David Jones, which require active client management teams. The process of onboarding these enterprises can be extensive.

Figure 8: Merchants by Category, Afterpay. Source: Afterpay Touch Group

For inbound inquiries, merchants simply complete a brief form requesting details such as average order value and total annual sales. Afterpay will then contact the merchant within 2 business days to discuss the partnership. The business also has a large network of specialists in the online industry, including integrations with leading e-commerce and POS platforms. Afterpay provides extensive technical support to merchants during the initial integration stages as well as continuous maintenance as needed to maintain positive stakeholder relationships. For larger businesses, Afterpay's sales and client management teams will consistently be searching for potential merchants to approach, as well as maintaining the strength of existing relationships.

Industry Overview:
Introducing the buy-now, pay-later industry

Gone are the days of layby, where the idea was to pay off purchases over the next three months before you could get your hands on the product. The transformation of shopping into a form of instant gratification first led to an explosion of credit cards – but with it, the monthly shock when opening the bill…

As people – in particular the younger generation – started waking up to the hidden dangers of credit card spending, the popularity of buy-now-pay-later services surged. According to ASIC, there were approximately 2 million consumers using buy-now-pay-later services in Australia in 2018 with 1.9 million transactions in the month of June. This is an uplift from 400,000 consumers in 2016 with 80,000 transactions in June.

In parallel, there has been a meteoric rise of merchants offering buy-now-pay-later arrangements – with Zip Money and Afterpay signing 50x and 45x more merchants respectively over the same 2 years from 2016 to 2018. The total revenue of the major buy-now-pay-later providers has increased from $32m to $78m in this same period.

Not only is the industry growing rapidly, but it is also extremely diverse in the business models that are operating. Consumers can use Zip Pay, Humm and Afterpay for up to AUD$1,000, $1,400 and $2,000 of credit respectively - and all with a slightly different method of repayment and fees charged. These arrangements are also no longer limited to smaller 'everyday-luxury' purchases. Buy-now-pay-later can now be used to finance solar panels, health services, travel, electronics and even everyday necessities such as groceries.

Afterpay's Competitive Landscape

With the lucrative opportunities presented by the BNPL industry, more and more businesses are entering and shaping this diverse market.

Domestic Competitors – Australia & NZ

Zip Pay and Zip Money (Zip Co)

Zip Co was founded in Sydney in 2013, and just like Afterpay, they started with the aim of disrupting the everyday use of credit cards. Zip Co offers two types of payment schemes in Australia and New Zealand - Zip Pay and Zip Money. Zip Pay offers interest-free repayments for small online shopping purchases of up to AUD$1,000, while Zip Money is for larger credit lines ranging from $1,000-30,000, with interest accrued after a specified interest-free period. Unlike Afterpay's rigid fortnightly scheme, Zip Co prides itself on its flexible payment options ranging from weekly, fortnightly or monthly. Zip Co went public on the Australian Securities Exchange in 2015, issuing 20 million shares at 20 cents each. Today, the business has a market capitalisation of AUD$1.2 billion.

Because Zip Co's business model differs slightly from that of Afterpay, namely it charges interest, it is registered as a credit provider. While Afterpay has the advantage of being able to use an instant verification process at checkout, Zip Co customers must apply for an account, and once approved, may begin making purchases through the service in much the same way. Zip Co is constrained by strict protocols under its *Australian Credit Licence and the National Consumer Credit Protection Act* (2009), which Afterpay is not. However, this may not be the case in future, as regulatory bodies such as ASIC are beginning to question whether Afterpay's lending practices should also be more closely watched.

zip
own it now, pay later

Humm (Flexigroup)

Flexigroup, which pioneered the BNPL market 20 years ago, has now made a come-back after consolidating two legacy financing products, Certegy EziPay and OxiPay, earlier this year. The new BNPL platform, Humm, sets itself aside from Afterpay by allowing shoppers to spend up to $30,000 interest free. The business offers two flexible credit tiers, where purchases of up to $2,000 are paid back over a 2.5- or 5 month period, whilst purchases above $2,000 are repaid over a 6 to 60-month period. Flexigroup's stock price jumped 24 percent after announcing they had signed on Myer, Ikea and IVF group and City Fertility as merchants. Humm now boasts around 15,000 partners, and the business accounts for over 17 percent of BNPL transaction volumes.

Openpay

Although Openpay was founded in 2012, the business had only just begun to scale in 2019, operating in Australia and New Zealand. Unlike other BNPL services, Openpay targets a specifically older demographic of 30 to 40-year-olds. As such, they offer longer interest-free repayment terms, ranging from 2 to 36 months, with credit limits of up to $20,000. They do, however, require stricter credit checks. Additionally, Openpay allows shoppers to amend their instalment schedule as needed, without incurring any additional fees or interest.

International Players

As a Swedish that company launched in 2005, Klarna has been in the business for longer than its competitors and continues to thrive. Klarna allows shoppers to pay later in four instalments, interest-free. Considered one of Europe's most valuable tech unicorns, the company currently spans 14 different markets, with Sweden and Germany being the largest. Klarna launched in the UK in late 2014, before expanding into the US in 2015. The company currently boasts 60 million customers worldwide and is available through more than 130,000 retailers, processing an average of 1 million transactions each day. Compared to Afterpay's focus on fashion and beauty, Klarna has better usage coverage across categories including Home & Garden, E-commerce & Shopping, Sports, Vehicles and 19 others. Additionally, Klarna announced they raised USD$460 million in equity funding, at a post money valuation of USD$5.5 billion, making the company one of the highest-valued private fintech in the world. Domestically, the Commonwealth Bank of Australia has marked its entrance into the BNPL market, investing USD$100 million in the Swedish company.

Sezzle has a stronghold in the North American market, in particular the US and Canada. It has 5,000 active retailers and over 429,000 customers, and also offers 4 equal instalments over 6 weeks with 25% down payment at the time of purchase. It also listed on the ASX on July 30, 2019, in an attempt to capture the Australian investor market that understands the BNPL model and is traditionally dominated by Afterpay. The company's share price rose 82% above its IPO issue price of AUD$1.22 within two hours of listing – a positive market sentiment rivalling that of Afterpay's.

Splitit is an Israeli company that provides instalment payment solutions for consumers. It provides many flexible options such as monthly instalment repayments, but up to 36 months interest free. Shoppers also get the chance to try out items for up to 90 days, decide if they are going to keep it, and then go on a payment plan. There is also the flexibility for customers to split up payments across two credit cards for customers that have insufficient funds on a single card. Further, like Afterpay, it is available across websites, in-store point of sale and also on mobile apps. Splitit listed on the ASX at AUD$0.20 on January 31, 2019 and saw an 800% rise in share price in the following 6 weeks. However, as at 20 September 2019, it has fallen down to $0.49.

Instalment Offerings by Traditional Players

With the growing need for more responsible money management fuelling the lucrative growth of the BNPL market, card issuers such as Visa, Mastercard and American Express have been quick to join the instalment payment method trend.

Most prominently, Visa is shaping up to be a key rival in the credit industry after announcing the launch of a pilot program for instalments using existing credit or debit cards. Visa reported that instalments represented USD$1.2 trillion in payment volume in 2017 globally, and this sector has been growing 15 per cent year-over-year, twice as fast as credit cards. It also cited a recent study showing 74% of respondents think instalment payments are helpful for budgeting, and alleviate the stress of making large purchases. Visa plans to officially launch its instalment scheme by 2020, however, it will be a long struggle to convince its card issuers to take up this service. Nevertheless, its global presence and existing goodwill with customers may see Visa strongly tap into the BNPL markets worldwide.

However, Afterpay announced that it had 'entered agreements with Visa which will form the basis of a strategic partnership to support the development of innovative new solutions and business growth in the US market.' Some questions have been raised: what opportunities can this bring for both parties? Can this be expanded to other markets in order to ameliorate the threat of Visa as a competitor? Or are their missions too different?

Figure 9: Key Competitor Comparisons

	Market Capitalisation (AUD)	Flexible repayments	Other fees (e.g. admin fees)	Dominant Markets	Maximum limit (AUD)
Afterpay	$6.51bn	✗	✗	Australia, New Zealand, UK, US	$2,000
Zip Co. (Zip Money & Pay)	$1.07bn	✓	✓	Australia, New Zealand	$10,000
Humm	$715.82m	✓	✓	Australia, New Zealand	$30,000
Openpay	Unlisted	✓	✓	Australia, New Zealand	$20,000
Klarna	Unlisted	✗	✗	Sweden, US, Europe	Based on individual credit history
Sezzle	$387.73m	✗	✓	North America - US and Canada	$1,000
Splitit	$149.7m	✓	✓	US	$20,000
Visa	$412.7bn	✗	TBC	Global	TBC

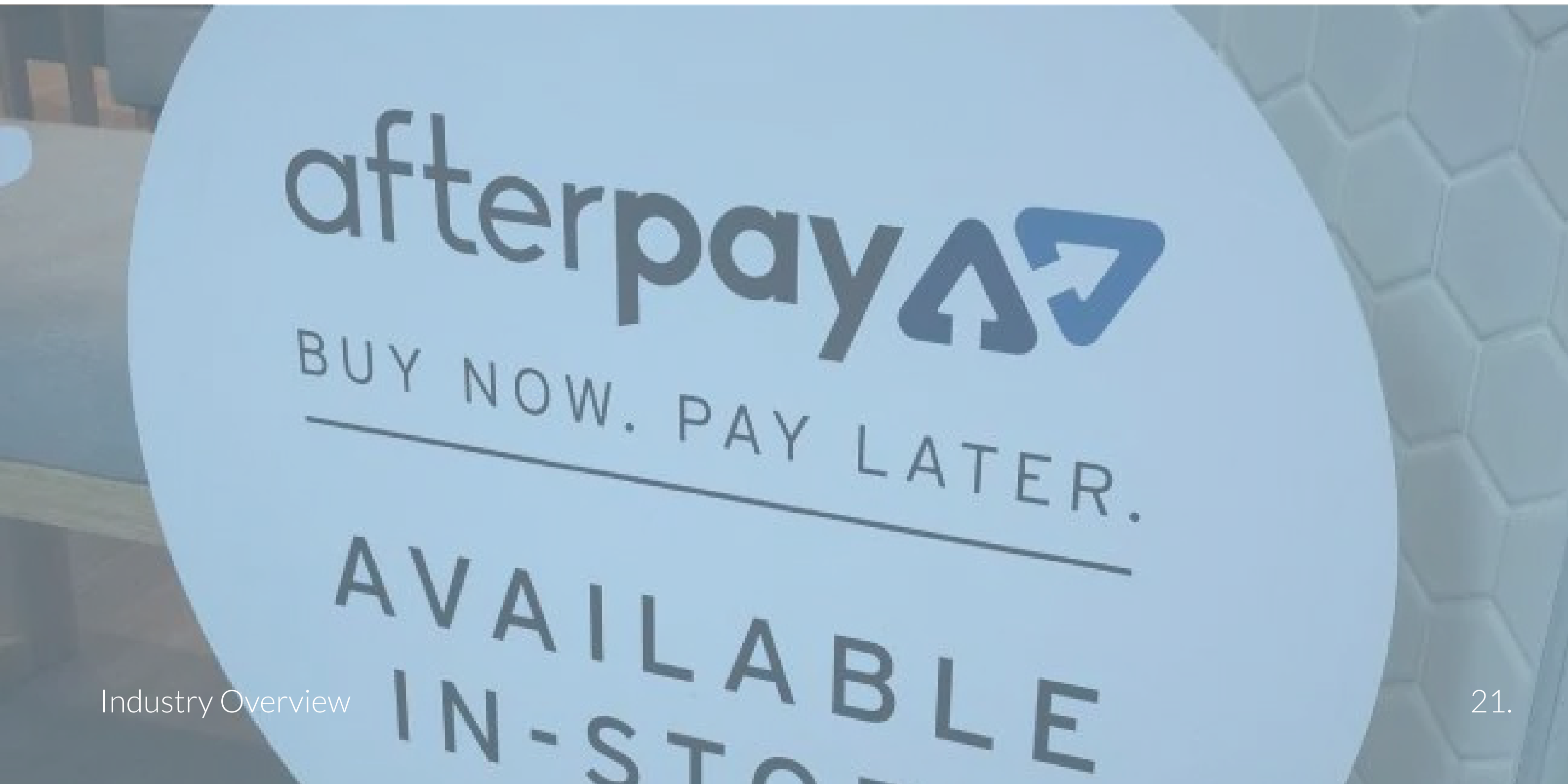
Moving Forward: Issues and Opportunities

Playing Catch-Up: Regulation in the BNPL Industry

Regulators worldwide are facing the challenge of adapting regulations to align with the rapidly changing fintech industry. Deciding exactly how the industry should be regulated has caused much controversy, with legislation such as the *National Consumer Credit Protection Act* (2009) and *Anti-Money Laundering and Counter-Terrorism Financing Act* (2006) implemented before Afterpay was conceived.

The BNPL industry is facing increasing regulatory scrutiny, with the Australian Financial Complaints Authority receiving hundreds of complaints regarding "unauthorised transactions, incorrect fees and negative impacts on credit ratings." There are calls for applying the national credit code to BNPL services, fuelled further by headline stories of underage buyers purchasing alcohol through Afterpay, and users using credit cards to sustain their BNPL accounts.

At present, the industry is working to establish a minimum set of standards that can govern controversial issues, such as determining a customer's ability to repay instalments. Whilst the specifics may be unclear, it is essential that BNPL services consider the implications of more stringent regulations on their future operations and business models. The key question emerges: what should regulation look like? Where does APT fit into the picture?



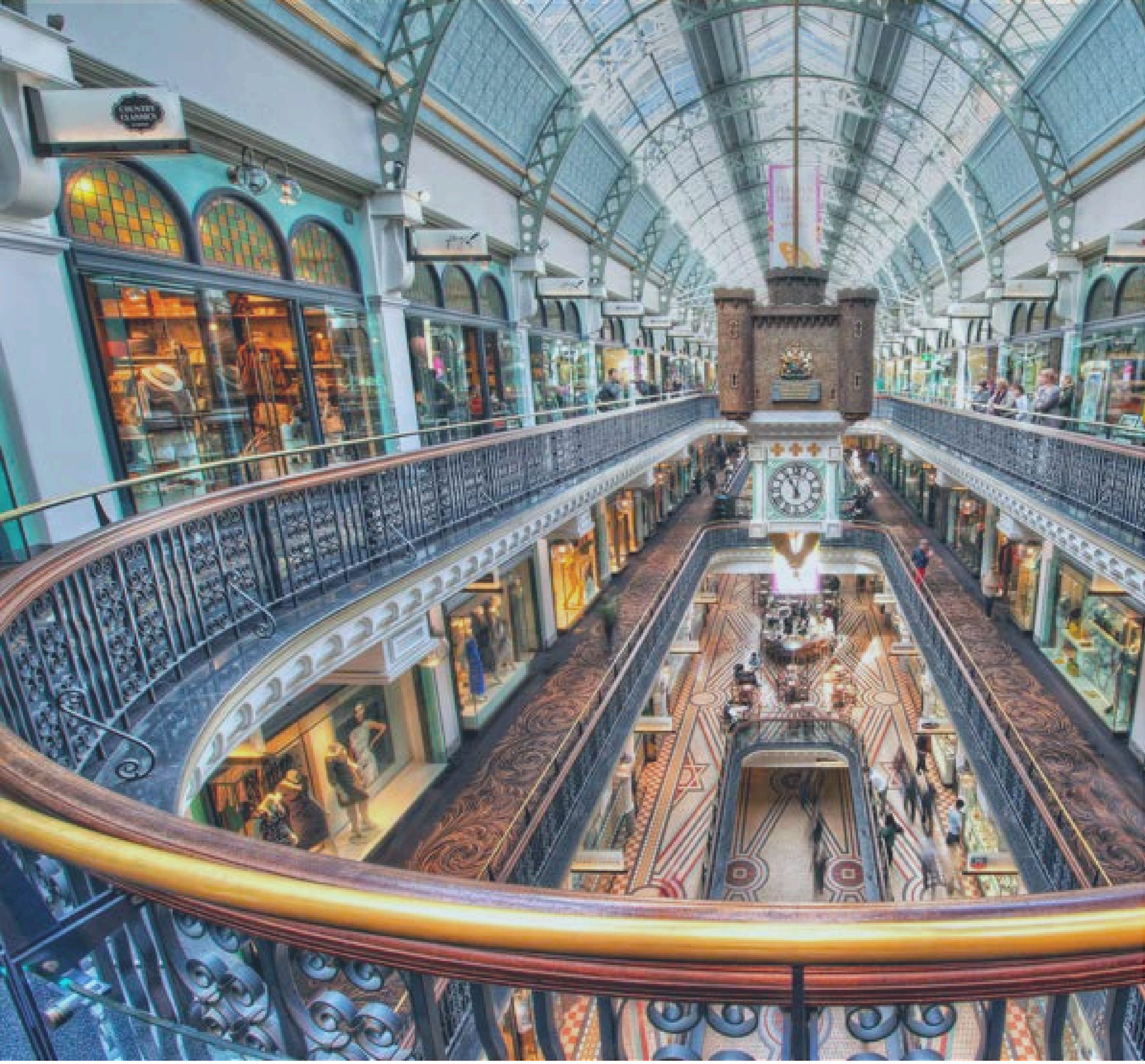
Managing Global Expansion

Afterpay has recently ramped up their global operations, expanding into the world's major retail markets, namely, the US and UK. However, with each new market, Afterpay must consider a range of factors including funding arrangements, distribution networks, marketing methods and consumer culture.

Even in Afterpay's entry into the US and UK, methods of entry and funding arrangements differed. Afterpay expanded into the US consumer market in mid-2018, with the support of a USD$20 million investment from US venture capital fund, Matrix Partners. The strategic rationale for partnering with Matrix was to create a "world class team with global responsibility". Analysts at Goldman Sachs have estimated the US market to be 15 times larger than Australia, representing huge growth opportunities for Afterpay.

In comparison, Afterpay entered the UK through a share purchase agreement with ClearPay. Similar to the Afterpay model, ClearPay is a UK based payments company through which customers can purchase items up to £450 in value and make repayments in three interest-free monthly instalments.

Unable to retain the Afterpay trademark which had already been taken by a Dutch company, Afterpay needed another strategy to accelerate and de-risk their entry into the UK market. In August 2018, Afterpay announced the conclusion of a Share Purchase Agreement with ThinkSmart Limited (AIM:TSL) to acquire 90% of ClearPay Finance Limited (ClearPay) shares for a total consideration of 1 million Afterpay shares, which had an approximate value of AUD$18 million. Within the agreement conditions, Afterpay also has a call option to acquire the remaining shares held by ThinkSmart, exercisable any time after 5 years from completion.



By having majority stake, Afterpay was able to immediately take over day-to-day management of Clearpay. Strategically, Afterpay intends to initialise its UK expansion by focusing on online-only. After this, they intend to delve into in-store capabilities by utilising the local networks of the ClearPay entity and engaging with relevant retailers with a local UK presence.

The question remains, does Afterpay have the experience and capabilities in place for truly global scalability? The payment behaviours and preferences of the millennial market in the UK were found to align with Afterpay's strategic plans, making the geography a viable place of entry. Can Afterpay's success be guaranteed in different market landscapes, if it chooses to enter? How can Afterpay best manage its global ambitions?

Competitive Pressures

Afterpay's disruptive offerings enabled it to reach AUD$1.5 billion in market value within its first four years of operating. However, newer and bigger players have entered an increasingly crowded space both within Australia and internationally.

In the past, Afterpay has possessed several aces that have laid the foundation for success. A number of industry and customer trends – including a rise in online shopping and a mistrust of traditional credit – certainly provided Afterpay with a solid foundation for growth. However, the simplicity of Afterpay's business model also has a role to play in meeting the untapped needs of its core customers. The idea of structured repayments in instalments on a no-interest basis has become immensely attractive for millennials who view Afterpay as a budgeting tool to manage cash inflow and expenses. This gives Afterpay an advantage over traditional credit cards with high APRs (Annual Percentage Rates) and fees, leading to increased customer acquisition.

Whilst customer satisfaction is integral to Afterpay's philosophy and mission, its key growth drivers come from increased merchant/business uptake of the Afterpay platform. Afterpay's first mover advantage has allowed them to spread the BNPL platform across major retailers both online and in-store. Importantly, scale and market dominance are a key differentiator for Afterpay. Firstly, Afterpay generates a majority of revenue from merchant cuts for each customer purchase. Secondly, new merchants are driven by the prospect of higher conversion rates, and are therefore more inclined to adopt Afterpay over its competitors, if its customer base is larger.

However, are these advantages sustainable going forward? Should Afterpay look towards changing its product offering to capture different customer demographics, or is it time to revamp their business model?

Check-Out: Closing Remarks

The simplicity of Afterpay's platform and service, as well as its dominance in the Australian and New Zealand market, have been crucial to its tremendous success to date. However, with Afterpay facing pressure on all fronts, domestically and internationally, it is looking for new opportunities to 'Grow, Perform and Innovate' in order to maintain their position as a market leader.

Afterpay has a clear-eye view for the future, with their strategy centred on "global merchant and customer growth, platform innovation and global support and infrastructure". The business took the first steps towards executing this strategy with their expansion into the US and UK markets, which have been met with positive feedback from retailers and strong consumer uptake.

However, although these geographies boast large millennial consumer markets and significant growth opportunities for Afterpay to tap into, overseas expansion does not guarantee success. It is often major opportunities like these which are packaged with major risks, such as regulatory, macro-economic, competitive, and consumer threats. This is a dynamic line, and Afterpay must walk it carefully.

Financials and Appendix

Exhibit 1: ASX: APT share price since IPO

Exhibit 2: Merchant income margin

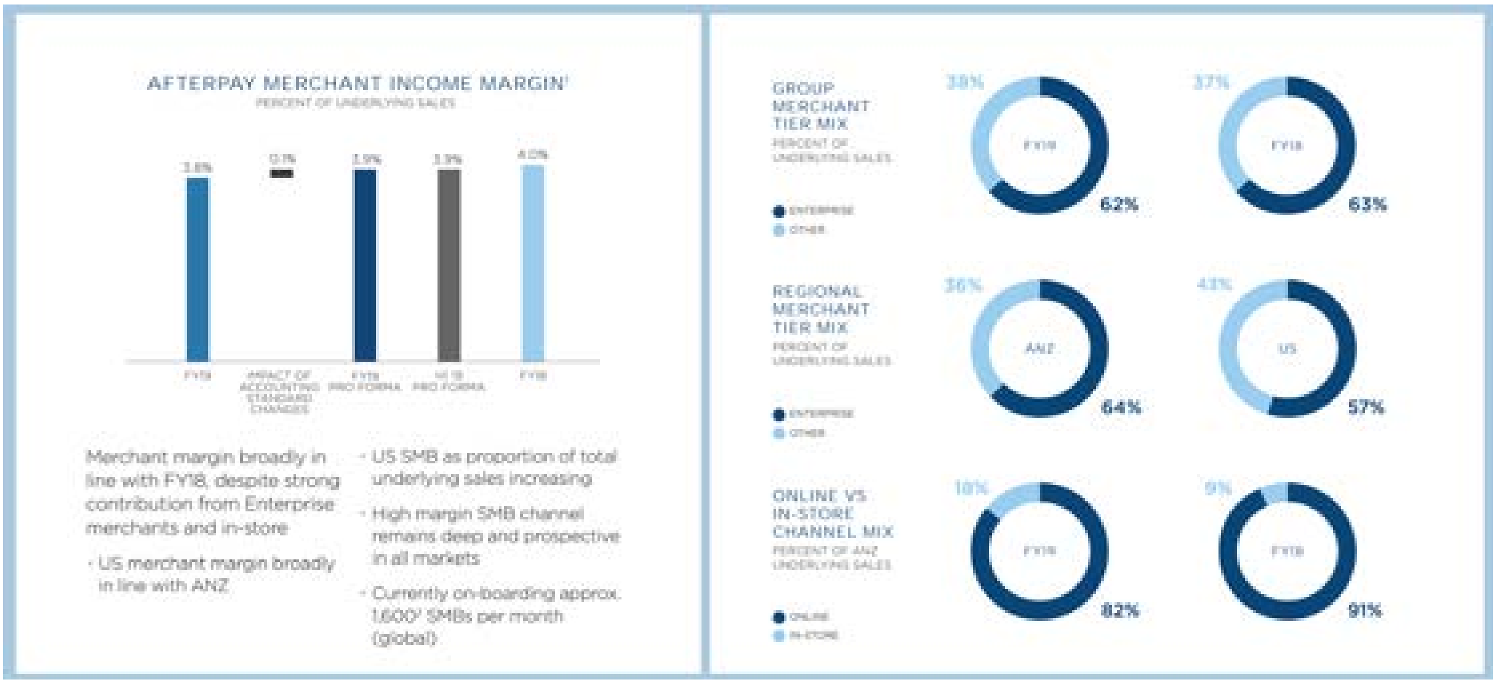


Exhibit 3

COMMENTARY

Underlying sales +140%; >4.6m global customers as at 30 June 2019

Extended leading position in ANZ; including in-store

US grew above expectations

Strong launch in UK, already >200k customers (no material contribution in FY19)

Gross losses significantly reduced (1.5% of underlying sales to 1.1% pro forma[2])

Net transaction losses (NTL) stable notwithstanding higher losses in US & UK (early life cycle)

Net transaction margin (NTM) remains strong (2.4% pro forma[2]) notwithstanding significant contribution from lower margin US business

- ANZ NTL and NTM continues to improve with time, driven by high returning customer rates and increased purchasing frequency
- US merchant margin in line with ANZ. NTM positive in FY19 (pre-accounting changes) and consistently improving over the period

A$M (UNLESS OTHERWISE STATED)	FY19	AASB9 ACC. IMPACT[2]	FY19 PRO FORMA[2]	FY18	CHANGE[3] %
UNDERLYING SALES	**5,247.2**	**-**	**5,247.2**	**2,184.6**	**140%**
ANZ	4,314.1	-	4,314.1	2,170.4	99%
US	927.5	-	927.5	14.2	6,447%
UK	5.6	-	5.6	-	-
AFTERPAY INCOME[1]	**200.9**	**4.6**	**205.5**	**88.3**	**133%**
% OF UNDERLYING SALES	3.8%	0.1%	3.9%	4.0%	-
GROSS LOSS	**(58.7)**	**2.2**	**(56.5)**	**(32.6)**	**73%**
% OF UNDERLYING SALES	(1.1%)	0.0%	(1.1%)	(1.5%)	-
NET TRANSACTION LOSS (NTL)[4]	**(22.2)**	**2.2**	**(20.1)**	**(9.3)**	**116%**
% OF UNDERLYING SALES	(0.4%)	0.0%	(0.4%)	(0.4%)	-
OTHER VARIABLE TRANSACTION COSTS (INCL. FINANCE COSTS)	(59.3)	-	(59.3)	(23.3)	154%
% OF UNDERLYING SALES	(1.1%)	-	(1.1%)	(1.1%)	-
NET TRANSACTION MARGIN (NTM)	**119.3**	**6.8**	**126.1**	**55.7**	**126%**
% OF UNDERLYING SALES	2.3%	0.1%	2.4%	2.6%	-
AFTERPAY EBITDA	**58.9**	**6.8**	**65.7**	**41.0**	**60%**

Exhibit 4: Afterpay App

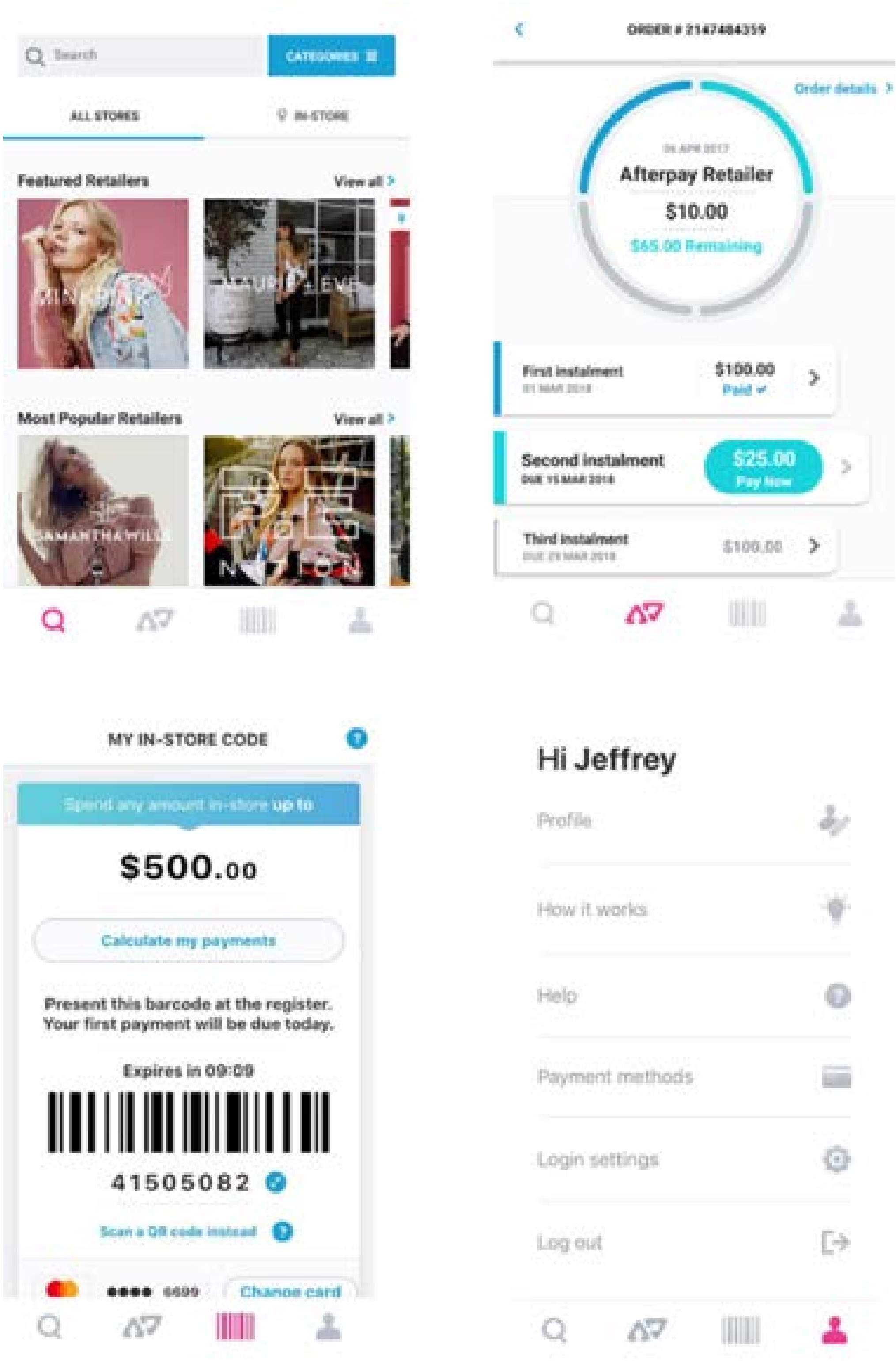


Exhibit 5: Some Merchant Partners of Afterpay, Source: Afterpay H1 FY19 Results

Exhibit 6: Mission and Values

Exhibit 7: Afterpay's analysis of domestic and global opportunities

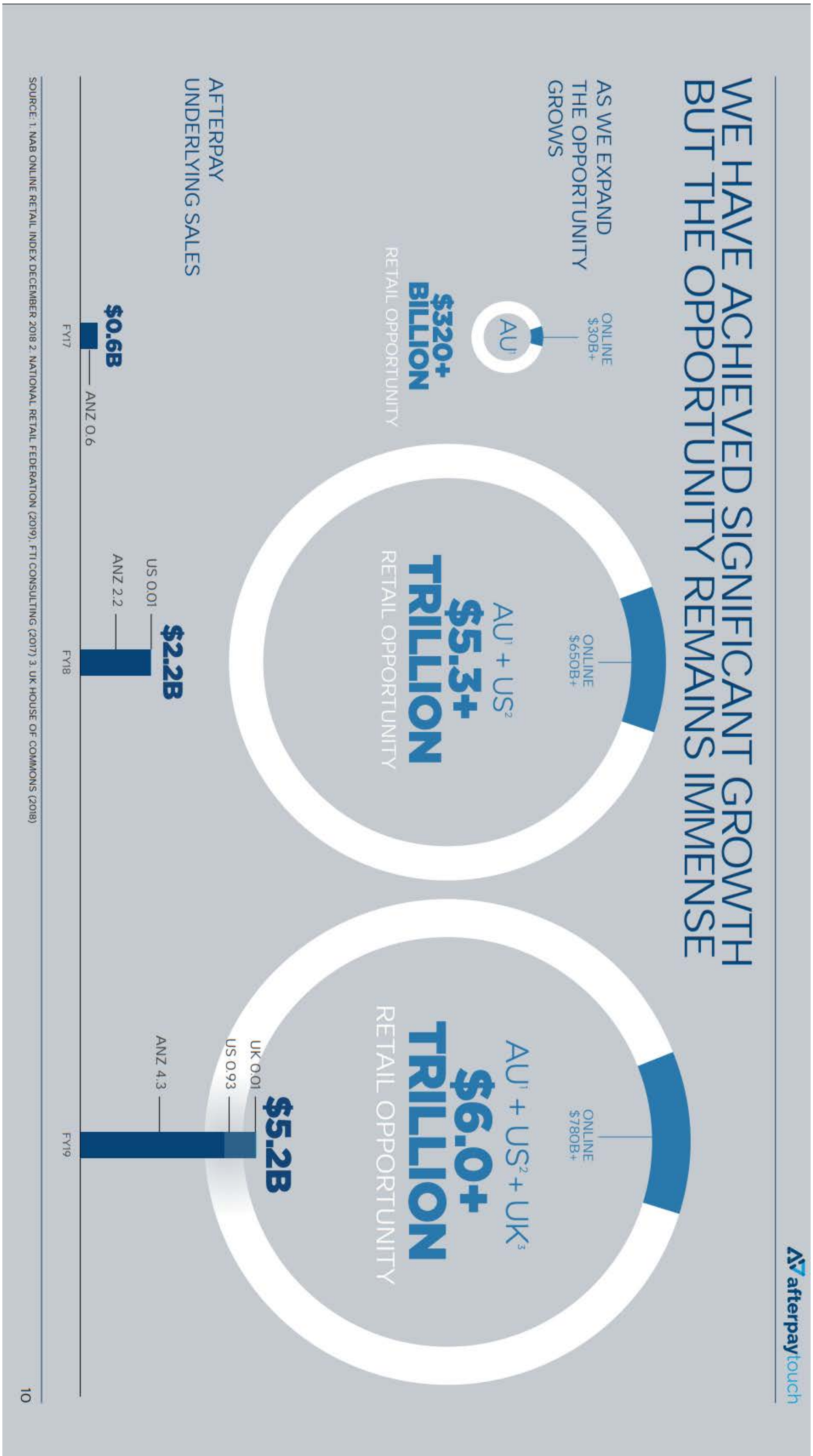


Exhibit 8

ABC NEWS

Calls for greater regulation of 'buy now, pay later' services like Afterpay and Zip Pay

7.30 By Michael Atkin

Updated Fri 16 Aug 2019, 3:00pm

Popular "buy now, pay later" services like Afterpay and Zip Pay have been the subject of more than 250 complaints to the Australian Financial Complaints Authority in the eight months to the end of June.

The complaints relate to unauthorised transactions, incorrect fees and negative impacts on credit ratings.

"I really think that complaint levels are the tip of the iceberg," Gerard Brody from the Consumer Action Law Centre told 7.30.

"Many people won't even know where to go when they've got a complaint with a buy now, pay later provider.

"Even if people do go to the Australian Financial Complaints Authority because, for example, they've been over extended, there may be not much that the complaints body can do, because the laws don't apply to buy now, pay later providers."

The buy-now-pay-later fast credit revolution has rapidly changed how we shop.

The services are being used in millions of transactions each month and allow a shopper to buy something immediately and pay the amount back in instalments without interest being charged.

Depending on the service, the maximum amount that can be borrowed varies between $1,000 and $30,000.

It is particularly popular with shoppers aged between 18 and 34 and is widely available in major retail outlets, from department stores to fashion brands.

And now the Morrison government is grappling with whether more protection is needed for the millions of shoppers who are already using the popular services.

'Not always sustainable'

Single mother of three Lucy Kalwila lives north of Brisbane and is a regular user of Zip Pay.

She believes there should be increased regulation.

"It should change, because sometimes when you get a Zip Pay it's too rich a loan to be given and it's something that's not always sustainable," she told 7.30.

Ms Kalwila has been a Zip Pay customer for about four years.

She has suddenly found herself in financial hardship due to several large debts, including for a car loan, and her vehicle is at risk of being repossessed.

She was also forced to move several times after leaving a relationship.

This year she has used Zip Pay to spend about $1,200, mainly for a new couch.

She isn't aware of Zip Co doing any checks to verify whether she could still afford to buy it after her financial situation changed.

Lucy hasn't missed a minimum repayment of $40, which includes a $6 account fee each month, but she still owes $965.

But she says it is an added strain while she works with a budgeting service to address her other debts.

"I'm a good customer, I make all my payments," she said.

"I think it doesn't really bother them as long as I'm making those payments."

7.30 provided Zip Co with specific details about Lucy Kalwila's case, including her written consent to discuss it.

But Zip Co's chief operating officer, Peter Gray, refused to answer detailed questions, including about whether the company had performed a credit check this year before approving her recent purchases.

"For privacy reasons, it's difficult to sort of comment on specifics of any individual customer," he told 7.30.

"But what I can say is that we are conducting the relevant checks up front prior to extending credit to a customer.

"The only way they can actually continue to use our product is if they maintain a good repayment profile and remain an up-to-date standing on the account.

> "We would encourage any customer who is experiencing financial hardship to identify themselves to Zip and allow us the opportunity to work with them to find a solution."

Industry divided on regulation

The industry is divided on what further regulation is needed, with some key players arguing that applying the national credit code would stifle growth and unfairly affect customers and merchants by slowing down the approvals process.

The industry is working on a code of practice that could result in a set of minimum standards in contentious areas, such as assessing a customer's capacity to pay and limiting revenue from late fees.

Zip Co is experiencing rapid growth, with more than 1.3 million active customers, and estimates its revenue will reach $141 million by 2020.

It already carries out identity and credit checks on customers of its Zip Pay and Zip Money brands.

Mr Gray says his company only wants the national credit code to apply to services providing more than $2,000 to the customer, which would mean its Zip Pay brand is exempt.

"Zip supports further regulation for the sector on the basis that it was industry specific (and) dealt with the massive uptake in services," he told 7.30.

"Zip put forward a policy recommendation as part of the Senate inquiry, and some of those recommendations were for further regulation, including income verification on applicants.

> "We are (already) pulling banking transaction information on our customers prior to them signing up."

Its key competitor, Afterpay, is also against having responsible lending laws applied.

Afterpay is currently being audited by Australia's financial intelligence watchdog, AUSTRAC, over concerns about how it identifies and verifies customers, and its compliance with legal obligations under anti-money laundering and counter-terrorism financing laws.

But Flexigroup, which operates the service Humm and has 1.4 million customers, says it is open to considering the national credit code.

Corporate regulator, the Australian Securities and Investments Commission (ASIC), is also keeping a close eye on the sector and now has the ability to use its product intervention power if it sees consumers are losing out.

It found that more than 40 per cent of users had incomes of less than $40,000 and many were students or working part time.

It also discovered outstanding debt was growing fast, to the tune of more than $900 million in June 2018.

ASIC hasn't decided if the sector should be subject to responsible lending laws like other credit providers.

A senate inquiry recommended the Federal Government consider further regulation, in particular around ensuring that services assess the financial situation of consumers before extending them credit.

Currently buy now, pay later is not subject to the National Credit Act and its code, meaning the providers are not required to meet responsible lending obligations, such as assessing someone's suitability for a loan or having hardship arrangements, something consumer groups want to change.

Credit for people who can't get a credit card

Scott Phillips watches the buy now, pay later sector closely and believes that in an economic downturn outstanding debt could pose a risk.

He is the chief investment officer at Motley Fool, which provides advice to share market investors.

> "If we end up with some sort of economic shock, the individual consumer cost and, frankly, the economic impact is something we're just not prepared for," Mr Phillips told 7.30.

"The very attraction, very reality of Afterpay and Zip Pay, is that people who haven't got a credit card or weren't eligible for a credit card, are now using this form of consumer debt.

"We simply don't know how likely they are to pay back — or not pay back — the debts if, or when, things get tight.

"If unemployment spikes, if they lose their job, are they more likely or less likely to pay back those debts or to cause financial stress on the company or the economy as a whole?"

Financial counselling services are experiencing increasing numbers of people coming forward who are in significant debt for other reasons but are also struggling to repay buy now, pay later amounts.

> "At the national debt helpline we are receiving more and more calls from people who have debts to a buy now, pay later provider," Mr Brody said.

"It's often one of many debts that people have, like credit cards, utility debts and others, and it's adding to people's debt stress.

"As it grows more and more throughout the economy, we can only expect that there'll be more people who have got debts to buy now, pay later providers."

But Zip Co's Mr Gray doesn't see the $700 million worth of outstanding debt held by his company as a problem.

"No, (it's not unsustainable), this is demonstrated in the results of our underwriting models and our focus on responsibility," he said.

He defended his company's record on responsible lending, saying it rejected more than 35 per cent of applicants, which resulted in fewer customers charging late fees.

"With Zip, one in 100 customers is late in any given month, and this is in comparison to credit card, (which) has one in six, or other buy now, pay later products that are also about that one in six," he said.

"Of that, one in 100 that is late, a very small number identify themselves as having a financial hardship or having experienced a change their financial circumstances."

Consumers 'being left high and dry'

Gerard Brody wants the Federal Government to act quickly.

He is calling for responsible lending obligations to be applied to the buy now, pay later sector.

"If the Morrison government doesn't act, consumers are being left high and dry, they're being left at the whim of these providers, and the risk is that they will become more and more over indebted," he said.

In a statement, a Government spokesperson said it was still considering its response to the Senate inquiry's final report.

It also said it had passed legislation earlier this year giving ASIC the power to intervene in the buy now, pay later sector.