



6% p.a Target
Distribution



Double Digit returns
since inception



Long/Short
Australian Equities



Proven Track
Record

Fund Update

The month of July is usually pretty quiet for investors. Apart from those that are required to provide quarterly cash flow reports, most companies are in “blackout” after the close of their financial year on 30 June - so they won’t say much till they report their earnings in August.

The Fund is a concentrated portfolio and there happened to be little news from the stocks held in July, though a few had positive announcements and they went up modestly. While there was no negative announcements, on balance the portfolio drifted lower.

For the month, the Fund fell -1.72% (after fees) versus a rise of 1.10% for the S&P/ASX200 and 0.68% for the Small Ords.

Ironically, the major drag this month was Afterpay (ASX: APT) which fell -18% (on no significant news) and detracted about 0.5% from the portfolio. Immediately after month end Afterpay announced it was being acquired in an all scrip take-over by Square (NASDAQ: SQ) and rose by 32% over the next 2 days.

Return Summary Since Inception¹(after all fees)

Since Inception (p.a.)	12.33%
1 Month	-1.72%
3 Months	-0.14%
6 Months	4.59%
FYTD	-1.72%
1 Year	37.45%
3 Years	17.42%
5 Years	10.74%
7 Years	9.71%

Monthly Portfolio Metrics

Outlook Stocks (Long)	16 Positions: 73%
Outlook Stocks (Short)	1 Positions: -2%
Event, Pair and Group (Long)	3 Positions: 14%
Event, Pair and Group (Short)	1 Positions: -2%
Cash	18%
Gross Exposure	91%
Net Exposure	82%

Portfolio Analytics Since Inception²

Sharpe Ratio	0.66
Sortino Ratio	1.17
Standard Deviation (p.a.)	16%
Positive Months	63%
Maximum Drawdown	-29%
Avg. Gross Exposure	90%
Avg. Net Exposure	79%
Avg. Beta	0.63
Avg. VAR	1.2%

¹ Inception date is 2 July 2012. Past performance is not indicative of future performance. Returns may differ due to different tax treatments.

²Glossary of terms can be found on the Fund’s website at www.monashinvestors.com/glossary/



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This month's update looks back at our investment in Afterpay and our initial thoughts on Square as a combined entity, which will also trade on the ASX following the merger. The chart below tracks Monash Investors investment history in Afterpay.

Afterpay Limited – Investment History



Source: FactSet (weekly share price data), Monash Investors

Initially cautious

We first saw Afterpay on its IPO roadshow in 2017. It seemed like a great idea: charging a merchant 4% to fund their customers' purchase, and getting paid back in 6 weeks. The same money could be re-lent over 8 times in a year, giving a return of more than 32%. But the idea of letting people in effect take their "lay-buy" home with them prior to payment seemed overly risky to us, and we passed on the IPO, so we could assess their bad debt experience.

Once we saw that their bad debts were not a problem, we established an initial position, but we were still wary of potential regulatory issues, because of the media and lobbyists focus on predatory consumer lending. To be clear, we do not consider Afterpay's approach to Buy Now Pay Later (BNPL) to be in any way predatory, but we were concerned that it may be unfairly regulated.



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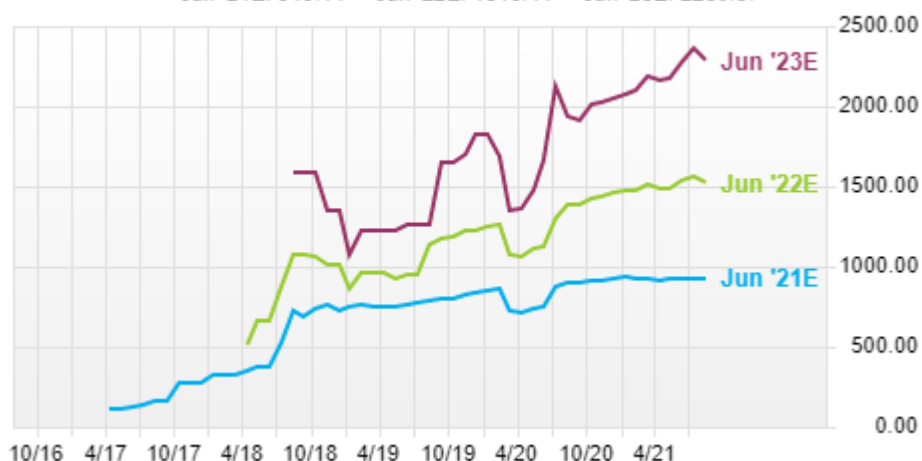
The first time we sold completely out of Afterpay was within 6 months of our initial purchase when we became aware that ASIC was closely monitoring it. An adverse legal interpretation from the regulator could have rendered APT's business worthless. However, following the regulatory all clear we re-established our position. Our assessment was subsequently re-enforced by the Australian Senate's Inquiry over 2018/19 that was supportive of Afterpay, too.

Forecasting Afterpay's growth in revenue and earnings

Back in FY18, Afterpay had grown its revenue to \$140m and was on its way to doing \$260m in FY19. Our forecasts had them achieving close to \$500m in FY20. We were well ahead of the analyst consensus for that 2 year estimate. The sell side analysts forecast that level of revenue "only" being achieved in FY21. We were right about FY20, and as it turns out, they actually will do over \$900m in FY21.

Analyst forecasts for Afterpay revenue, since 2017 (source: Factset)

Jun '21E: 919.14 Jun '22E: 1516.41 Jun '23E: 2280.87



We were able to rely on our past experience of recurring business situations and patterns of behaviour when making our forecasts, which also gave us the confidence to go against consensus. Some of our observations are outlined below:

- Consensus forecasts underestimate significant change
 - Merchant behaviour
We were confident extrapolating the current growth rate of merchants putting Afterpay on their websites as a payment option, because it led to an immediate increase of 10-15% in their on-line sales.
 - Customer behaviour
A big difference between our forecasts and the rest of the market was that we incorporated the increased frequency of use by customers the longer they had been users. In the first year customers average use was once a quarter, by year 2 it's once a month, and around year 4 it hits more than twice per month. Including this behaviour into our forecasts ramped up our longer term revenue forecasts dramatically. The below chart depicts this behaviour well.



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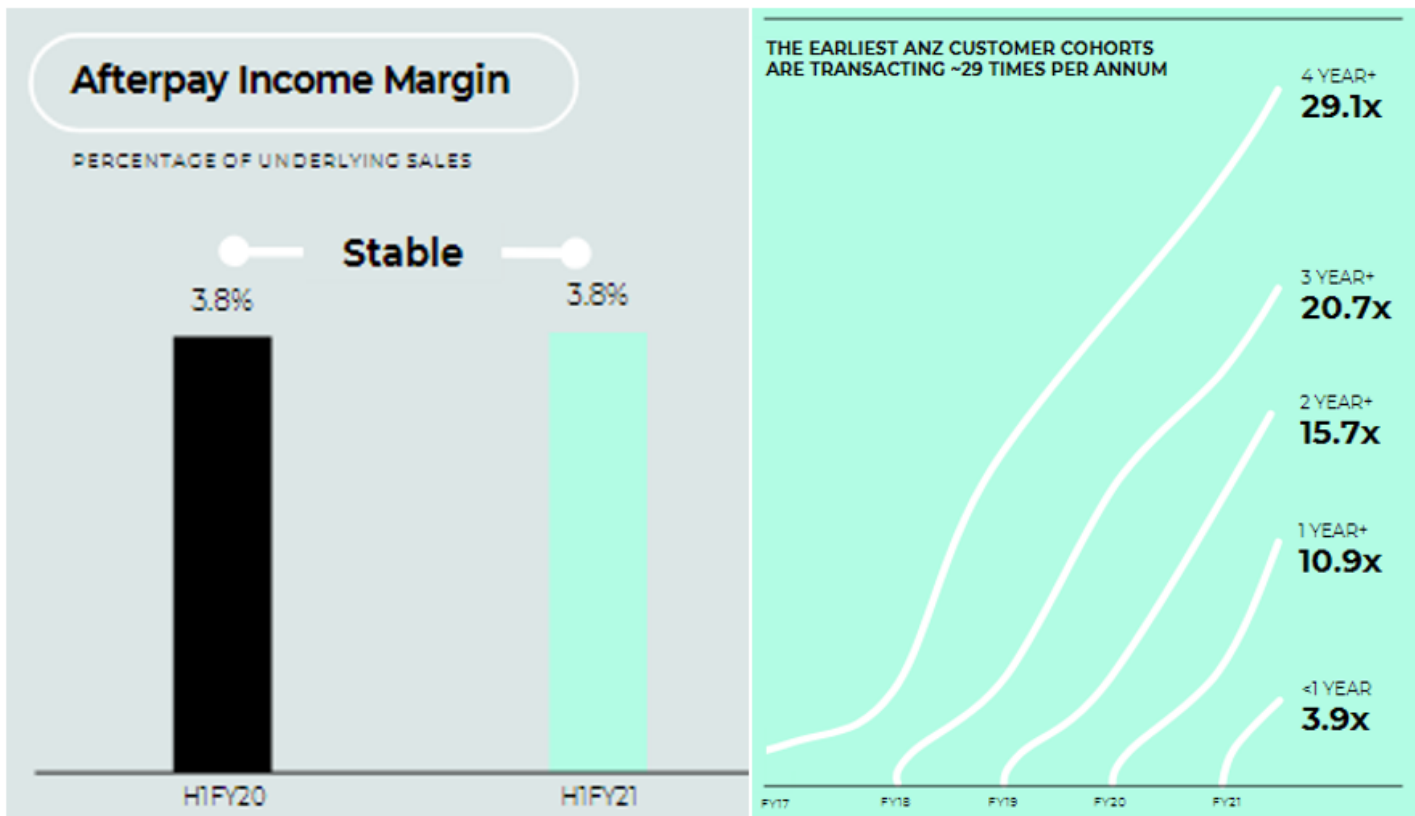


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- Entering new markets
Another big difference in our forecasts is that we were early in incorporating the effect of Afterpay entering new markets of New Zealand, Canada, the USA and Europe. We did so at the first evidence of they were likely to do so for each market.
- Behaviour of analysts
 - Managing expectations
Analysts don't need to risk their careers by making bold forecasts, even if these forecasts are realistic. The consequences of being wrong when overly optimistic are quite severe for their reputation. It is much better for them to be "proved right" on a stock they recommend and have to raise their numbers due to a "positive surprise". Analysts were consistently undercooking their forecasts for Afterpay.



Source: Afterpay

What is Afterpay worth?

One of the big debates around Afterpay was what it was worth. Fund managers who were not invested often claimed that it made no money and therefore its share price made no sense.

This superficial dismissal of the Afterpay stock opportunity was wrong for two main reasons:

- They do make money
 - The income margin has remained stable at around 3.8% of Gross Sales



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- Australia was profitable on a standalone basis
- The company was only loss making in the near term because of the early stage of its expansion into the large markets of Canada and the USA.
- They were using near term measures of valuation
 - A longer term valuation metric such as Discounted Cash Flow that could look out 5+ years showed that the stock was extremely cheap
 - On a standalone basis Australia was worth \$7 per share.
 - Incorporating NZ, Canada and the USA increased our valuation to \$90 per share.
 - By the time we added Europe it was up to \$135 per share.

Managing the stock weight and exiting at \$153

We take an absolute approach to controlling risk in our portfolio, and so regardless of how big a stock gets in the index, we don't want its weight to get too far out of line with the majority of stocks in our portfolio. That way the few that we get wrong will be more than offset by the rest of the portfolio.

As a result we kept the Afterpay stock weight around 7% most of the time despite its increasing price. On two occasions though we did halve the weight before buying back in. Once was on regulatory concerns (again) and the other in the early days of COVID before it was clear that bad debts would not be a concern.

At all times we maintained a strong view about our DCF price target, and based on this price target we completely exited at \$153. At that price we were getting paid for everything we expected Afterpay to achieve in the following 8 years, and we didn't need to stick around any further to wait for the market to agree with us, or to see if it would play out as expected.

Competition concerns and buying back in

We were also concerned that competitors might cause price competition for Afterpay, thereby reducing the value of its future earnings. New competitor announcements had been a regular occurrence in the prior two years and hadn't concerned us in what was still an immature industry. But when PayPal launched its "Pay in 4" product in 2020, it was set about 30% cheaper to merchants than Afterpay. From that point on we were vigilant in looking for evidence of margin contraction in the industry but found none of concern.

Indeed, a month ago PayPal revised their merchant fees up, which was quite surprising and certainly made us less concerned about Afterpay's sustainability of future margins. By then Afterpay's share price had retreated from its highs and we saw enough upside payoff to our price target to justify buying back in, albeit at a modest position.



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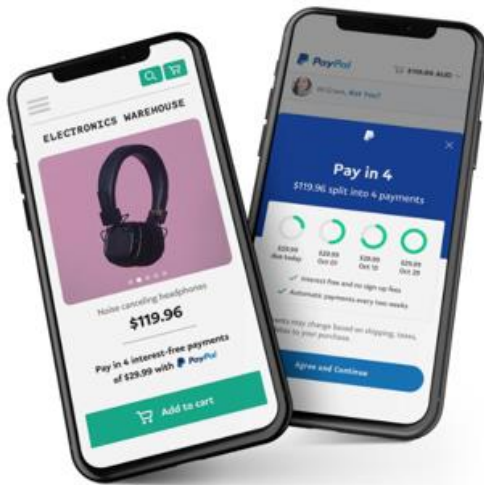
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Meet PayPal Pay in 4

A new buy now, pay later interest-free instalment solution at no additional cost.



No additional cost

Pay later functionality is included in your existing PayPal rate.¹

Standard rate for receiving domestic transactions

Transaction Type	Rate
Commercial Transactions	2.60% + fixed fee

Source: PayPal

Merging with Square and the future for investors

On the first business day of August, Afterpay announced a merger with Square. Square is a US based credit card processing business servicing “millions” of merchants (stated to be 4 million on the investor call) and also has a financial services “Cash App” used by 70 million consumers. This compares to Afterpay’s 100,000 merchants and 16 million consumers.

Square will acquire Afterpay via a Scheme of Arrangement which values APT at ~A\$39bn (based on Square's closing share price of US\$247.26) – all paid in Square scrip. The implied price is A\$126.21 per APT share (+31% premium to last close, +22% premium to the 10 day VWAP). As part of the arrangement, Square has agreed to set up a secondary ASX listing via Chess Depository Interests (CDIs). APT shareholders will be able to elect receive Square's NYSE listed Square Class A common stock or CDIs.

The rationale for the merger is compelling. Afterpay is the BNPL leader in a nascent market, and is complimentary to Square’s Seller App and its Cash App products. Square will integrate Afterpay into both, accelerating Afterpay’s take up at a rate much greater than even Afterpay was already growing. See the summary below. Square’s revenue was already expected to grow in excess of 100% this year prior to the announcement of this acquisition.

Square rose a further 10% following the announcements which is an early indication that the deal makes sense. This of course dragged Afterpay’s price up to and Afterpay’s share price will move pretty much in lockstep with Square. We are currently assessing the value of the combined entity.



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~100K
Merchants



Millions
of Merchants



16M
Consumers



>70M
Consumers

Last twelve months (LTM) basis as of 6/30/21

LTM basis as of 6/30/21 unless otherwise stated

Products	BNPL	30+ products including Point of Sale, Managed Payments, CRM, Business Banking, Online, Hardware, Developer Platform, more	Products	BNPL	P2P, Banking, Stocks, Bitcoin, Taxes
Channels	\$16B of GMV (\$21B AUD) >85% Online	\$140B of GPV ~45% In-Person	Consumer Base	Global Millennial/Gen Z, higher-income Coastal U.S.	Primarily U.S. Millennial/Gen Z South and southeast U.S.
Seller Size	Enterprise merchants generated majority of GMV	Moving upmarket: Mid-Market merchant segment drove strongest GPV growth	Commerce	In-app shopping discovery \$975 in average GMV per consumer as of FY21 (AUD \$1.3K)	>10M monthly Cash Card actives Growing Boost rewards platform
Verticals	Primarily retail	Diverse mix of verticals	Engagement	Multiple purchases per month on avg, with repeat buying	18 transactions per month on avg for monthly actives, up 40% YoY
Geographies	>50% GMV from outside U.S.	>85% GPV from U.S.			

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