Emerchants Ltd vs Afterpay Holdings Ltd: Which is the best payments solutions stock?

Matt Brazier | March 13, 2017

Payment solutions stocks **Emerchants Ltd** (ASX: EML) and **Afterpay Holdings Ltd** (ASX: AFY) are highly regarded by the market right now.

Emerchants has a market capitalisation of $380.5 million and reported a net profit after tax (NPAT) of $1.4 million in the first half of 2017. Meanwhile, Afterpay has a market capitalisation of $403.9 million and reported a loss after tax of $1.4 million for the half-year to December 2016.

Although the current profitability of each company does not even come close to justifying their valuations, they are both growing rapidly. Emerchants' revenue increased 207% to $32.4 million and gross profit rose 213% to $25.4 million in the first half of 2017. Meanwhile, Afterpay's revenue improved from $0.2 million to $6 million and gross profit went from $0.2 million to $4.8 million.

So Emerchants is profitable whereas Afterpay is not, it has five times the revenue and gross profit of Afterpay and is growing revenue faster in absolute terms. Afterpay is growing revenue faster in percentage terms, but this growth is off a tiny base of $0.2 million. Yet despite Emerchants' superior financial performance, it is currently valued at a 5.8% discount to Afterpay by the market.

Not only is Emerchants more reasonably valued than Afterpay based on the above financial metrics, but in my opinion it also has a superior business model. Emerchants provides reloadable and non-reloadable pre-paid payment cards in Europe, the US and Australia. In addition it provides virtual payments in the US. Businesses use its cards for a variety of purposes including managing employee expenses, customer gift cards and to encourage spending in entertainment venues.

Afterpay effectively lends money to online consumers which they repay over a period of a couple of months in fortnightly instalments. The merchant gets paid by Afterpay immediately and Afterpay takes on the risk of non-payment by the consumer.

For this service the merchant pays Afterpay a few percent of the transaction value. Unsurprisingly, the solution is very popular with consumers and vendors since consumers get to borrow money at no cost and vendors experience increased sales.

There are two key reasons why the business model of Emerchants is superior to Afterpay.

- Emerchants takes on no credit risk, whereas Afterpay takes on the risk that the consumer fails to pay. Consumer lending is high risk which is one reason why credit cards have such punitive interest rates. In a benign economic environment like we are experiencing now defaults are low and Afterpay's business model appears to work, but the company could be in trouble during a recession. Not only does Emerchants avoid this risk but it also gets to keep any unused gift card balances on top of its typical fees – an upside risk mirroring Afterpay's credit risk. Unused balances represented 59% of revenue in the first half of 2017.

- Emerchants gets paid in advance to provide its services which is why it generates strong operating cash flow ($9.6 million in the first half of 2017). In contrast, Afterpay pays vendors upfront and then receives the money from consumers up to two months later. This explains why the company had $31.4 million of negative operating cash flow in the first half of 2017. The faster Afterpay grows, the larger these outflows will become and they need to be funded either by shareholders or lenders. The first option directly impairs shareholder returns whereas the second option risks even more damage later should economic conditions deteriorate.

For me, Emerchants represents a much more attractive investment opportunity than Afterpay today, although both appear overpriced based on current profits.

Having said that, Emerchants' valuation doesn't look too excessive if you assume that its first half cash flows are sustainable. I suspect that they are for the most part because first-half NPAT included $5.1 million of depreciation, whereas the company only spent around $1.5 million on plant, equipment and capitalised intangibles during the period.

Personally, I would consider investing in Emerchants provided I could feel comfortable that the services they provide to the gaming industry are ethical (although these only make up a small proportion of total sales). Also, I would need to research the competitive landscape further to answer the following questions.

- What are the chances of prepaid cards being replaced by virtual alternatives in the future?

- How well is Emerchants positioned to respond to such a threat?

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