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AFTERTHOUGHTS ON AFTERPAY

Fintech innovators are breaking new ground worldwide. In Australia, analysts and commentators are excited about point-of-sale lender Afterpay. Over the past 2½ years, it has come from launch to a A$4 billion valuation. How?

Because Afterpay doesn't charge interest as such, it sidesteps credit regulations – and customer safeguards. Instead users, overwhelmingly buying from internet-based merchants, commit to paying 25% down, the rest in three interest-free instalments once a fortnight after the purchase is made. Consumer access to the Afterpay platform is easy: a few personal details, and a credit or debit card are all that's needed to set up an account; approval usually comes in a few seconds. And reports suggest that millennials in particular are signing up in droves: the company claims that 1 in 10 Australians are active users.

So how does Afterpay make money? Most visibly, there are late fees, charged at 25% of the transaction value or A$10, whichever is higher, with a cap of A$68 per transaction. Afterpay doesn't give bad debt write-off details, but it does say that only 5% of transactions incur late fees. What this means in dollar terms is unclear.

In fact, most of the company's revenue comes from merchants. Once signed up, they pay 4% commission on every Afterpay transaction: on an impressive A$2.2 billion of sales in 2017/8, that adds up to A$88 million. Even so, like most start-ups, Afterpay loses money – A$9 million last year. That hasn't stopped the stock market getting very excited: since being listed, its shares have soared 2000% to its current A$4 billion valuation. And launch in the US earlier this year has stoked the flames.

So, is there a catch?

Well, there are a few flaws in the model:

- First up, it's based on a legal loophole. And legal loopholes can be closed. The claim that late payment fees aren't interest by another name may or may not finally pass muster with the Australian Securities and Investments Commission (ASIC). For sure, in many markets American Express pulled off something similar on its classic charge cards. But the authorities are tougher now on FSI's, and after recent banking scandals in Australia, ASIC has reputational ground to make up.
- Crucially, how long will merchants accept a service fee that is up to four times what they would pay on a credit or debit card? Bear in mind that merchants in Australia and around the world have very successfully campaigned against "unfair" card charges.
- Afterpay's response to this is that they're creating incremental business – sales that the merchant otherwise wouldn't have made. That's always been a tough claim to support. For American Express, it's been a key part of the pitch; but the average transaction value at the Blue Box is around 50% higher than at Afterpay, where it's under A$150. And recruiting new merchants – and keeping them onside – has always been expensive.
- Instalment plans aren't new: they're available from many credit card issuers. Not usually at point of sale, admittedly, but if Afterpay were to become a real worry, it wouldn't take much tinkering to match them.

- This is a cash-negative business and it needs to be funded. Afterpay's breakneck growth means it needs to find finance facilities at the same headlong pace. And at affordable cost, too, at a time when interest rates are widely expected to move higher.
- Finally, there's a lot of excitement around the launch in the States. But two things need to be considered: first, how robust will Afterpay's "legal loophole" turn out to be in the US? Second, there's well-established competition in the point-of-sale loan market from the likes of Affirm and GreenSky.

Put it this way: it's always good to see businesses pushing the envelope. But my bet is that the folks who launched it would very much like an incumbent with deep pockets to come along, spot a way to fix the flaws, and buy them out.

Note on currency equivalents: at writing, $A1 = $US0.72, £0.55

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