Long Term Global Growth

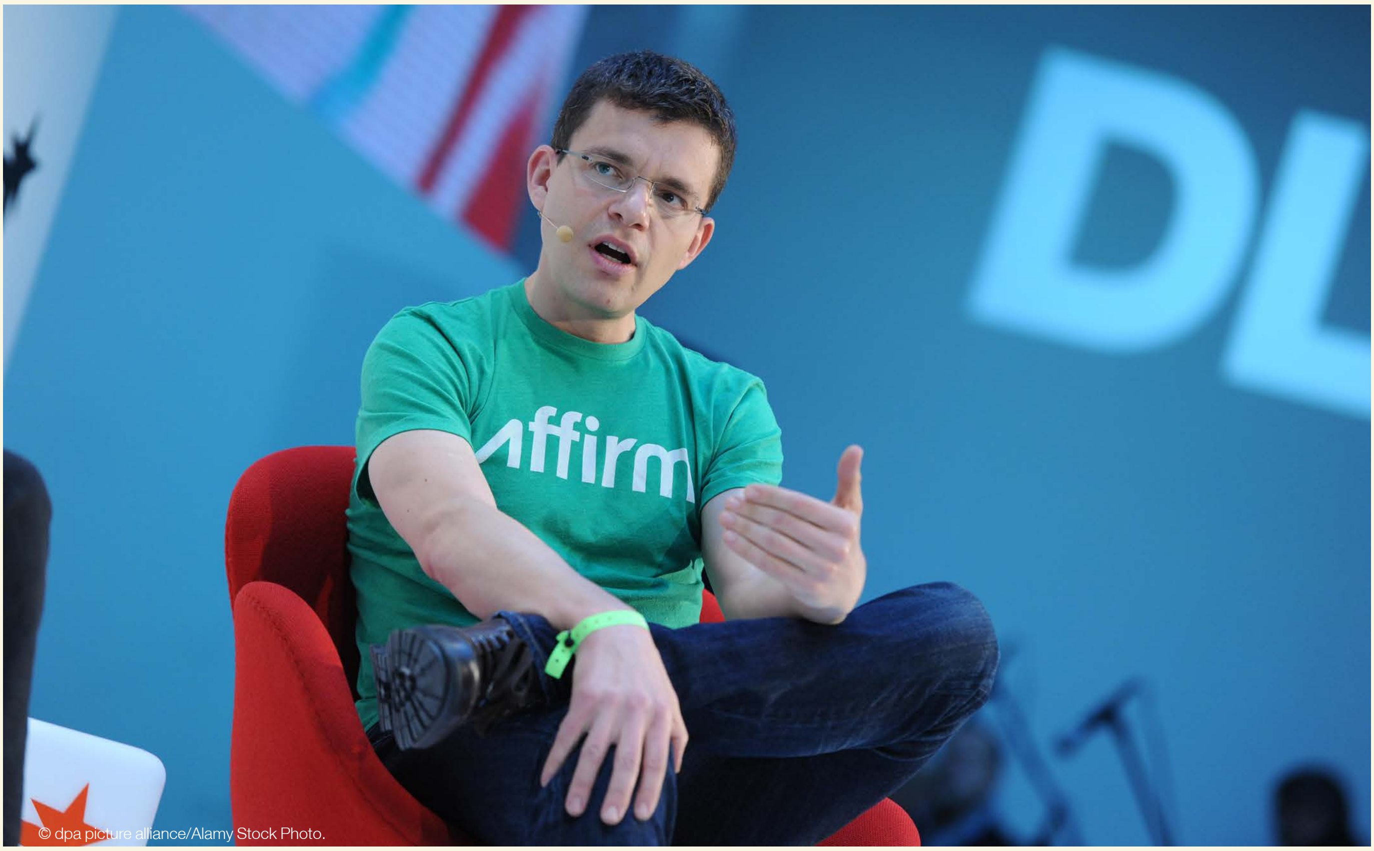
Reflections

January 2022

Consumer credit does not have a good reputation. It often conjures images of intimidating loan sharks, nefarious payday loan providers or, worse still, the Wall Street originators of the 'credit crunch' in 2007. Despite its shadowy reputation, credit (or lending) has played an influential role in the rise of civilisation ever since its recording in Mesopotamia in 2,000 BC, where farmers borrowed seeds issued against a later payment. From loans for consumers to buy their own home, carry out repairs, or a car to take them to work, prudent borrowing and lending can facilitate the efficient use of capital and accelerate economic progress when offered responsibly.

Four thousand years and 12,000km away from ancient Mesopotamia, Affirm, the San Francisco-based digital financial services company, is looking to restore the meaning of credit to its Latin origins, to 'trust or believe', with a simple mission of 'delivering honest financial products that improve lives.' The consumer credit market is laden with misaligned incentives. Lenders can increase profits through opaque charging structures, late fees and by keeping their customers indebted for longer. It's easy to disregard this mission as a mere marketing spin. Affirm, however, has walked the walk since its founding in 2012, by never charging late fees, providing transparency of costs, and pricing its products simply. Its commitment to the customer experience sets it apart from its peers. It is one of several reasons why we took a holding in the company in November 2021. we have followed Affirm with interest since investment manager Mark Urquhart first met CEO and ex PayPal co-founder Max Levchin in Sun Valley in 2016.

Affirm's offering is reassuringly straightforward for both customers and merchants. When a customer finally decides to take the plunge and buy the Pottery Barn bed, Expedia holiday or Samsung tablet that's been in their online basket, Affirm is a payment option alongside Apple Pay, PayPal and others. It provides the opportunity to split this payment over a few weeks to five years at rates starting at 0 per cent. With over 40 per cent of the sales it currently processes given at 0 per cent interest, one might rightly be wondering: "what's in it for Affirm?". The answer is simple: adding Affirm as a payment method delivers larger order sizes and converts more customers from viewers to buyers, so merchants are inclined to give them a cut of up to 15 per cent of the purchase price.



Max Levchin, Affirm CEO.

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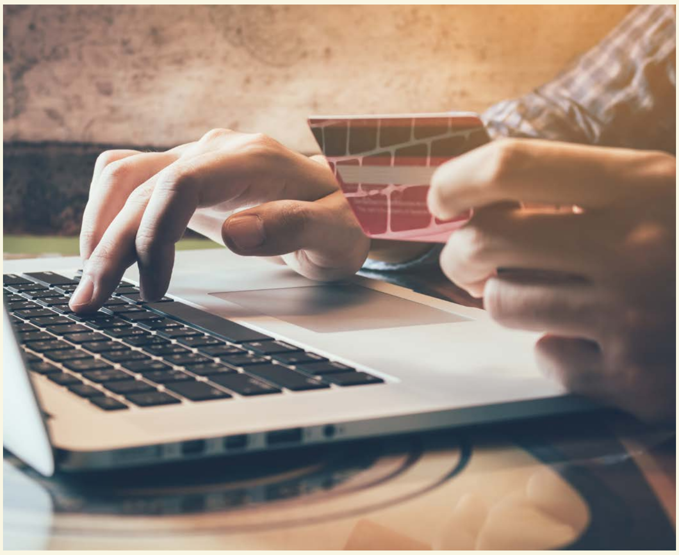
Beyond the obvious value proposition it offers at purchase, Affirm's enduring edge may lie in its technological expertise. CEO Max Levchin is a software engineer by trade and has built Affirm's technology stack and payments infrastructure from scratch, providing convenience for both consumers and merchants while giving it the ability to add new features and iterate at pace. An advantage that its partners, such as Shopify, have openly lauded. Its role in transactions also positions it to benefit from a rich flow of data that feed its proprietary credit models, optimising its lending criteria and minimising loans that are not repayable. Once secured, customers can see their balance on the Affirm app or website, where transaction data tailors product recommendations. In this way, Affirm turns from a payment option to an ecommerce platform with a quarter of all the Gross Merchandise Value (GMV) initiated via Affirm channels.

This recipe of mission-led founder, distinct culture, disruptive business model and a case for enduring competitive advantage makes for an enticing investment opportunity; propelled by self-reinforcing network effects. As Affirm woos more merchants and consumers, the value to both grows. The increased data flow improves underwriting and recommendation models, increasing scale improves margins. It's a compelling case; some of the recent numbers reinforce it. Merchant partners have grown from 6,500 a year ago to 102,000 today, primarily driven by a partnership with Shopify (another with Amazon is just beginning). Year-over-year growth in GMV (84 per cent), active consumers (124 per cent) and revenue (55 per cent) are all impressive. The potential for extreme upside is clear in our blue-sky case: that Affirm takes 25 per cent of the US credit card market in 10 years, resulting in $1tn of GMV. At a blended take rate of 3 per cent (lower than today), 30 per cent operating margins and 20 per cent tax rate circa $7bn in earnings. A conservative 20x multiple would mean a valuation of >9x that of today.



Despite our optimism, Affirm's share price was hit by stock market concerns about inflation and interest rates, as well as being recently named as one of the 'buy now pay later' companies investigated by the US consumer watchdog. Encouragingly, CEO Levchin has welcomed regulation that he thinks will bring a 'wild west' industry into the mainstream. We will continue to monitor these developments but believe the fundamentals of our investment thesis for the coming decade are intact. We embraced recent share price weakness to add to the holding in November last year and again in January. For a company set to transform the consumer credit industry and restore the meaning of credit to its Latin origins, we believe it deserves a place in the LTGG portfolio. We will continue to exercise trust and patience in the strength of the investment case from here.

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