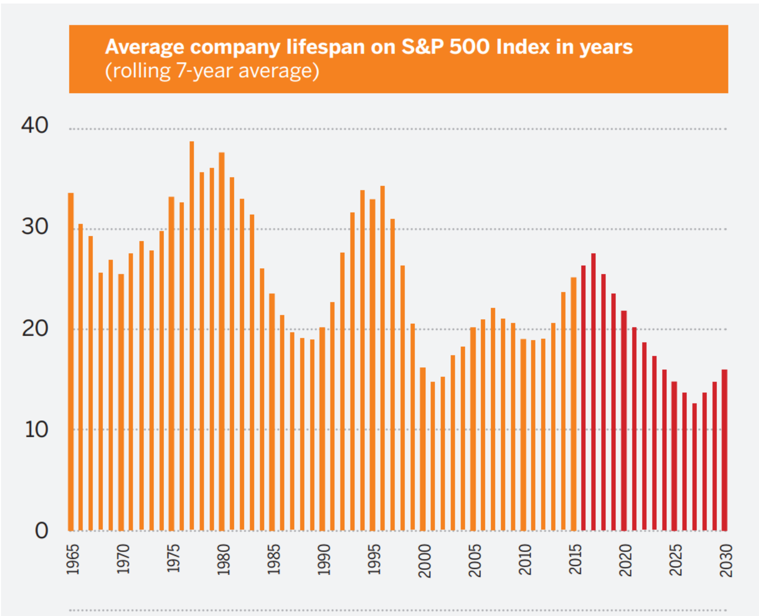
Strategy Notes – The growth and growth of Australian Fintech - July 2017

We have written fairly extensively in recent times around the widespread growth in disruptive industries and the increasingly fluid nature of the corporate landscape at present. While owner-managers of disruptive start-up businesses have perhaps never felt gifted with so many opportunities, the leadership teams of traditional incumbent businesses have never faced a more uncertain period in which to allocate capital.

To understand how pervasive the theme of change has become in corporate leadership today, a statistic from the recent **Harvey Nash / KPMG Global CIO Survey** conducted at the beginning of 2017 certainly provided a sobering view: of the nearly 4,500 Chief Information Officers (represented across 86 countries), some 25% have now moved to actively reduce the level of long term planning in their business (i.e. over three years) in response to the growing level of uncertainty in the global outlook.

It is quite extraordinary to consider an environment where capital allocators now feel increasingly reticent to invest in growth and innovation projects with a time horizon any longer than 36 months. With the corporate and technological landscape changing so rapidly at present, corporations are essentially now fearing that any initiatives implemented beyond a 3-year time period will soon be made redundant and ultimately serve as a waste of shareholder funds. In a strange corporate paradox, large businesses are now refusing to invest in long term innovation in fear of ultimately being superseded by competitive threats that have been generated as a result of businesses investing in long term innovation!

It would be of no surprise that the bulk of concerns come primarily from the larger cap, slower-moving incumbent business models that for so long have enjoyed such significant competitive advantages. A recent study into corporate longevity by consulting business Innosight highlights the average tenure of companies in the S&P 500 in 1965 was 33 years – this is forecast to fall to just 14 years by 2026. As the impact of innovation and new business models continues to impact the turnover rate of companies with the S&P 500, **at current churn rates it is expected that almost half of the S&P 500 will be replaced over the next 10 years.**

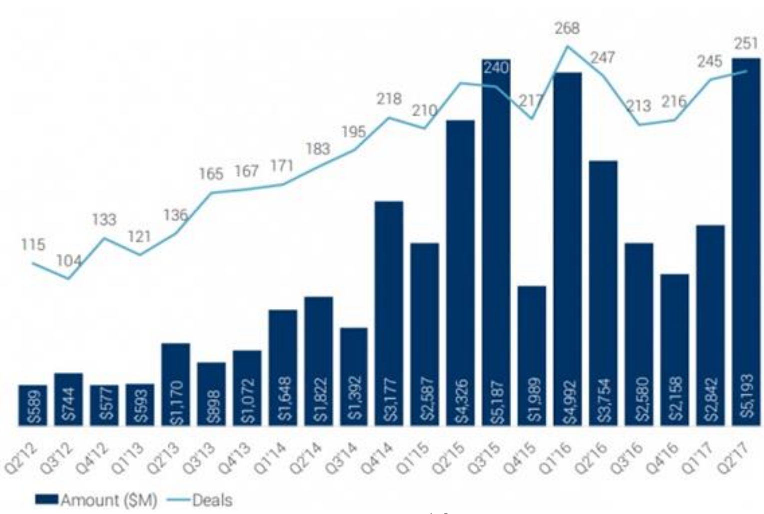


Source: Innosight

The Australian equity market is dominated by a similar selection of large incumbent business models that now face their own existential threats. We have written previously about the Amazon threat and how that might impact existing retailers and the grocery operations of the larger supermarket chains. The banking and financial services industry in Australia remains the other significant market sector now facing significant pressure from emerging financial technology ("Fintech") businesses endeavouring to take on the incumbent players in the innovation stakes.

For US banks and financial services, the growth in innovative fintech businesses is not a new theme, albeit the ability for these businesses to raise meaningful amounts of capital has certainly accelerated in recent times. For the major global banking and diversified financial players, the sheer quantum of capital now being raised to fund the growth of disruptive technology must be frightening: in the 2Q17 period just passed (i.e. just three months), more than $US5.1bn in new capital was raised in the US to venture capital-backed fintech businesses across 251 separate deals.

<u>Quarterly Global Financing Trends to VC-backed Fintech Companies</u>



Source: CB Insights

In Australia, the emerging fintech space has also begun to gather significant momentum, with Australian fintech businesses raising a cumulative US$656m in growth capital in 2016, a more than 12-fold increase on the US$51m raised by the sector in 2012. A virtual slew of innovative and nimble businesses are now all vying for their own part of the payments, lending, deposits and wealth management operations that were once solely the domain of the more traditional Australian banking and finance oligopoly. On KPMG Australia's estimates, there are now some 579 fintech operators in Australia, with the largest skew tilted towards the traditional banking strongholds of payments (128 companies) and lending (80 companies).

These are exciting developments to watch from the sidelines and obviously the recent progress in the space has created a virtual melting pot of innovation and idea-sharing across the emerging fintech community. This obviously hasn't gone unnoticed by the incumbent banking providers, however, with the Big 4 all rolling out fairly significant innovation projects of their own.

While 579 businesses is an impressive number, unfortunately the majority of these won't succeed. Whilst there will always be fabulous stories of a successful tech investor who backed an emerging pre-revenue business early and duly retired to the Bahamas, the reality of providing early stage risk capital is significantly different. Capital is often consumed quickly, competing technologies often emerge and a great many fantastic business ideas ultimately fail as a result.

Whilst we're not in the business of providing early stage tech capital by any means, as smaller cap public market investors **we do get the opportunity to uncover emerging businesses early on in their corporate lives that have survived the early stage venture capital rounds** and have subsequently gravitated toward listed company life. By simple virtue of making it to the public market, most of these businesses will have demonstrated a meaningful value proposition, strong customer demand profile and a management team capable of executing on growth.

It's a pleasure to meet with these businesses in their infancy to gain an understanding of the opportunities ahead of them (and also as an insurance check against any possible disruptive threats to our existing portfolio holdings). With successive meetings over time, we can grow more comfortable with the sustainability of the business model and growth profile on offer and (hopefully) find an appropriate time to deploy capital when the reward on offer is suitably commensurate to the risk.

In that regard, we have two investments in the Fund across the fintech space that we spent some time analysing and understanding prior to eventually deploying capital – both of which, interestingly, have their genesis in New Zealand.

Pushpay – The Business of Giving

Religion is a big business in the USA. With almost half of the adult population in the US (>150m people) attending church services on a regular basis, the volume of yearly donations from church members to their respective organisations exceeded US$120bn last year. Congregation members range in size from the humble suburban orthodox church that many Australians would recognise as a traditional place of worship, to the amphitheatre style 'mega-churches' predominantly seen through the southern US states that boast weekly attendances of 30,000+ members.

To give an example of the scale of some of these larger operations, The Potter's House Church in Dallas, for example, has a membership in excess of 30,000 people who congregate within a 17,700m2 building, built at a cost of US$45m and promptly paid off via donations within a four-year period. In 2014, fellow Texas 'mega-church' Lakewood Church (with weekly attendance of 40,000+) reported more than US$600,000 in donations had been stolen from a secure safe on-site, the proceeds of which had been collected from donations from just a two-day period.

As with every other aspect of our daily lives, cash is no longer king in the church-giving world and the humble collection plate has now faced its own disruptive moment. Whether it is the advent of 'tap and go' at the local supermarket or breezing through tollroads with an electronic tag, consumers are simply now far more accustomed to digitally parting with their hard-earned savings and increasingly feel inconvenienced by the need to physically deposit or transfer cash or cheques.

Auckland-headquartered **Pushpay Holdings (PPH)** provides a unique exposure to level of donations in the faith-based sector and the move toward digital donations in the space. The company essentially provides a digital giving and engagement platform for individual churches which is downloaded as an app by church members in order to facilitate their donations online. The app comes at no cost to the consumer and allows a congregation member (once registered) to make a donation in under 10 seconds, authenticated via a passcode or fingerprint imprint. The platform then allows the church to communicate with its members directly, whilst also keeping track of donation data (both at the individual and broader levels).

The company makes it money by charging the underlying churches a monthly recurring subscription fee to host the app and provide the various analytics and ongoing support to each church's operations team. As with any other platform payments provider, the business also generates revenue by taking a small percentage of the total donation volume (at a rate in line with other consumer payments providers). This provides the business with two key earnings drivers: the underlying number of churches using the app and also the amount of donations subsequently bequeathed through the digital channel.

We have followed the business since it was dual-listed on the ASX in October 2016, given it was providing a differentiated solution in a relatively fragmented industry and provided a unique exposure to the underlying structural move toward online payments. At the time, the business was displaying impressive growth in on-boarding small and mid-size churches throughout the US, though was still unprofitable and early in its journey of transitioning focus to larger enterprise-style church groups. Whilst highly sophisticated, our initial discoveries indicated the larger churches typically ran older legacy systems and were proving to be slow initial adopters of new payment technology. The incremental addition of smaller churches are beneficial to the company, however it would be demonstrating success in bringing on-board the so-called mega-churches that would prove the precursor to a dramatic lift in revenue and an overall industry 'proof of concept'.

Fast forward 8 months and Pushpay has converted close to half of the top 100 churches in the US, with the company now providing services to 10 of the top 20 largest churches by attendees. The growth in adoption amongst the larger churches has created a fairly powerful network effect across what is a relatively close-knit church going community, essentially validating the product as industry 'best practice'. We would expect this network effect to continue to drive further adoption and therein continue to lower the cost of customer acquisition going forward. The quantum of donations processed by the company now annualises at just under US$2 billion per annum, generated across more than 7,000 separate (mostly church) organisations.

For every new relationship/ church that comes on board, the Pushpay team roll out a tailored app specific to that congregation. With 7,000+ customers, that makes the business a fairly prolific app publisher as a result, with the business ranked the 5th highest app publisher globally on the Apple App Store in FY17.

With customer acquisition now continuing to gain momentum, the second earnings lever will come from increasing overall transaction volumes and in shifting the mix of total giving towards the digital channel rather than cash. This is a neat play on a broader structural growth trend that we have already seen play out across the consumer retail market and it would be difficult to see an impediment toward greater digital giving as a percentage of the total pool over time. The adoption of digital giving will likely be faster than experienced in the retail channel, however, given it benefits from a structural shift in consumer behaviour that has already been established and, until recently, there haven't been an online solution to offer the service.

As part of our due diligence process on the company, we have spoken with several large US churches who have adopted Pushpay, with the feedback garnered from those discussions overwhelmingly positive from not only a functionality perspective, but also around alignment of core values and ongoing engagement and trust. A pleasing development given the space in which they operate. We have also taken the opportunity on a recent visit to the US to meet with the finance and technology department of a large user of the technology in Texas who echoed similar sentiments. Most crucially, they highlighted an increase in the level of recurring giving, suggesting a higher quality stream of donations over time.

With the increased adoption by larger scale US churches creating a sustainable competitive advantage and high growth rate, we subsequently initiated a position in the company in July.

Ophir holds a position in Pushpay in the Ophir Opportunities Fund.

Xero Limited – From Xero to Hero

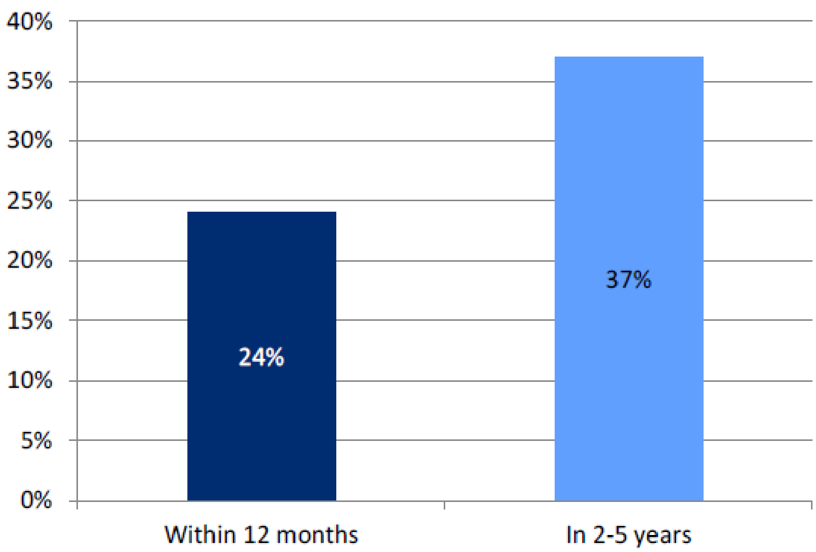
At the other end of the spectrum, **Xero (XRO)** is by no means an up and comer in the fintech space, nor an undiscovered gem. At NZ$3.7bn market cap, the business obviously already sits on the radar of many growth investors. While the business has enjoyed fairly spectacular early success (both from an operational sense and from a share price perspective), the inherent growth still available to the company remains an attractive proposition to us. Founded in 2006, Xero is now the leading cloud-based accounting software provider for small and medium sized businesses across Australia, the UK and New Zealand with over 1.03m active subscribers.

Investors can sometimes baulk at a meaningful growth opportunity purely as a result of an already stellar amount of growth achieved. One should never be afraid of a larger market capitalisation if the size of the underlying opportunity remains suitably significant. When looking at the growth momentum currently underway at Xero as a point of reference, of the 1.03m active subscribers listed at the end of March 2017, 318,000 of these were only added in the last 12 months.

Where PushPay provides investors with a unique exposure to leverage off the structural move towards online and mobile payments, Xero provides investors an opportunity to gain exposure to the increasing adoption of cloud-based software. With the advent of multiple personal computing devices and the need for employees to access software programs remotely, cloud-based solutions provide businesses and their staff with the ability to access files, data and applications at any time from any device. With the added cost benefits of not requiring investment in hardware to run many of these applications, the uptake of cloud software continues to grow. A recently released report from the ABS Business Characteristics Survey reported just under a third (31%) of SME's now use at least one paid cloud computing service, with the figure rising to as high as 60% for businesses employing in excess of 200 people.

For users of accounting software in the SME space, the adoption figure is slightly lower with penetration of cloud products in the accounting space sitting somewhere around the ~20% mark. As more SME's grow comfortable with cloud offerings in other areas of their business, it would be a reasonable expectation that this number begins to rise to at least a level in line with other software solutions. An industry survey conducted in December 2014 indicated 24% of existing SME's were likely to adopt cloud accounting software in the next 12 months, while 37% indicated they would likely do so in the next 2-5 years.

<u>Existing SME's Likely to Adopt Cloud Solutions</u>



Source: Rothcorp Survey, MYOB, Citi Research

Attracted to the growth in cloud-based software and following positive feedback from a number of early adopters across both SME's and their underlying accountants, we had been closely following the progress of Xero since about 2012. While we could see the underlying thematic remained highly attractive, we felt the valuation the market had placed on the business (using primarily a price/revenue based multiple) appeared excessive given the level of cash burn the company was still achieving and the likely requirement for a number of capital calls from investors to fund ongoing growth and R&D.

As a business that has never had a traditional desktop solution, the company has only ever been able to acquire customers via the conversion of existing incumbent desktop users that utilise a competing product (and/or in attracting new SME's as they are established). The accounting software space as an industry is certainly attractive one with an oligopoly-type industry structure, high barriers to entry, strong pricing power and relatively high switching costs faced by underlying customers.

Unfortunately, it is those attributes that makes it exceedingly difficult for a new entrant such as Xero to penetrate the market in their first few years of growth.

As is often the case with first movers in disruptive business models, the company is forced to invest significantly in new platforms and technologies to ensure a best-in-class user experience, alongside the establishment of a fairly sizeable sales and marketing team to ensure critical market share gains. These investments obviously come at a significant cost and while the market was prepared to look through near term losses and attempt to value the size of the prize at the end of the journey, we felt the risk/reward equation at that stage still felt too longer-dated. As a result, whilst we were exceedingly impressed with the product offering (backed by countless glowing reviews from a number of large industry users of the product) and recognised the structural tailwinds building behind cloud adoption, we determined to continue to stay close to the business but not yet deploy capital until we could gain a better understanding around the path for the business to be self-funding.

Fast forward a couple of years and the business has now begun to materially benefit from its early investment in product development and sales, with net subscriber adds continuing to grow well in the core markets of Australia, the UK and New Zealand. On the back of higher gross margins and increasing cost efficiencies across all expense lines, the business is now poised to move into positive EBITDA and operating cashflow from FY18, with positive NPAT and free cashflow expected shortly thereafter.

Our portfolios will always maintain a strong preference toward businesses that are generating free cashflow and as a result we need to be very confident in a company's ability to reach cashflow breakeven if we choose to deploy capital prior to the event. For Software-as-a-Service (SaaS) businesses like Xero, we can look toward the 'Lifetime Value' metric of the business to provide some comfort around future cashflows. Lifetime value is essentially the estimated aggregate gross margin that is contributed by the average customer over the life of the customer relationship.

In Xero's case, the quantum of the Lifetime Value has continued to grow significantly – the Company estimated total group subscriber lifetime value at NZ$1.5bn at the end of FY16, which figure has now been more recently updated as closer to NZ$2.2bn. That is effectively NZ$700m of added value to the business in less than a year via adding more subscriptions, a lower churn rate of customers and some pleasing increase in gross margin.

With a growing subscriber base in which to spread incremental marketing and R&D costs, the business is now in a fantastic position for future growth and is generating extremely high incremental returns on capital. With revenue growing at 40%, NZ$113m cash on balance sheet and a clear line of sight to reach cashflow breakeven within the next 18 months (with existing cash reserves), we have subsequently initiated a position in the business.

Ophir holds a position in Xero in the Ophir High Conviction Fund.

As always, thank you for entrusting your capital with us.

Kindest regards,

Andrew Mitchell & Steven Ng

Co-Founders & Portfolio Managers

Ophir Asset Management

This document is issued by Ophir Asset Management (AFSL 420 082) in relation to the Ophir Opportunities Fund & the Ophir High Conviction Fund (the Funds). The information provided in this document is general information only and does not constitute investment or other advice. The content of this document does not constitute an offer or solicitation to subscribe for units in the Funds. Ophir Asset Management accepts no liability for any inaccurate, incomplete or omitted information of any kind or any losses caused by using this information. Any investment decision in connection with the Funds should only be made based on the information contained in the Information Memorandum.