



ECON1239 – PRINCIPLES OF FINANCE

Assessment Task 3: CASE STUDY (100 marks - 40%)

The Case Study introduces an opportunity to review the learning materials and employ what have been learnt to the process of making investment, financing and dividend decisions. This assessment covers all the CLOs of the course, and it is worth **40% of the Final Result.**

THE CASE STUDY CONSISTS OF THREE PARTS (PART 1, 2 &3).

The case study involves a “Buy Now Pay Later” (BNPL) company – **AFTERPAY (ASX: APT)** that has recently generated much interest from institutional investors in the Australian stock market. As an analyst of an equity advisory firm, you are engaged to consult for the board directors and the executive management of AFTERPAY.

Founded five years ago in Sydney, Australia, Afterpay has over 10 million customers and 55,000-plus merchants now using the platform globally across Australia, US, UK (where it is called Clearpay) and New Zealand. Afterpay has also just launched in Canada. Afterpay’s global team is currently made up of more than 650 people and growing. Afterpay’s business model is completely free for customers who pay on time – helping

people spend responsibly without incurring interest, fees or extended debt. Afterpay empowers customers to access the things they want and need, while still allowing them to maintain financial wellness and control, by splitting payments in four, for both online and in-store purchases.

Your task is to consult the management of AfterPay with their financial planning and to evaluate the company's performance, by answering each question in Parts 1, 2 and 3. The company management has provided the following pro forma financial statements for your analyses.

BUSINESS REPORT (100 marks = 90 marks + 10 marks (presentation)).

As the analyst you are required to complete a business report covering all the questions that are raised in Part 1, 2 &3.
(<https://emedia.rmit.edu.au/learninglab/content/sample-report-structures>)

In your business report you will use economic techniques and analysis tools to:

- estimate the value of the company;
- check its financial health of the company;
- recommend to the management to “buy”, “hold” or “sell” strategy prior to investors’ roadshow;
- gain insights in the application of CAPM;
- present insights into the effect of financial leverage; and
- advise on hedging against the FX risk.

Part 1 (35 marks)

- a) Using the financial statements provided for Afterpay (see Table 1, 2 &3 below), calculate each of the ratios listed in Table 3 for Afterpay and the Information Technology (IT) sector for both **Y2019 and Y2020**. Present your answers in a formatted table? (5 marks).
- b) The management agreed that a ratio analysis provide a measure of the company's performance. They have chosen Sezzle as Afterpay's comparable company. Would you choose Sezzle as a comparable company? Why or why not? There are other BNPL companies that we could use as comparable companies. Discuss whether it is appropriate to use any of the following companies: Splitit, EML Payments, FlexiGroup, Zip, OpenPay, FuturePay, LayBuy, Affirm, PayPal Credit, Klarna. Explain your answer. (15 marks)
- c) Estimate the current market price of *Afterpay* equity. Suppose that Afterpay expects to pay dividends of \$5.75, \$6.00, \$7.50, and \$8.00 per share for the next four years. Thereafter, the company expects its growth rate to be at a constant rate of 6%. If this information is communicated to the market, and the market's required rate of return is 12%. (5 marks)
- d) You are required to recommend (to the management) a "buy", "hold" or "sell" strategy for Afterpay so that the management can make a better decision on the theoretical value of their company prior to investors' roadshow. Explain your recommendation. (5 marks)

- e) If the beta of Afterpay is greater than 1.0, the stock return will tend to exaggerate that of the market. In other words, the stock will tend to go up more than the market goes up and tend to go down more than the market goes down. Is this statement true or false? Explain your answer. (5 marks)

Part 2 (30 marks)

In your report to the board of directors of Afterpay, you are expected to:

- a) Explain what is meant by business risk and financial risk. Suppose Firm A has greater business risk than Firm B. Is it true that Firm A also has a higher cost of equity capital? Explain your answer. (10 marks)
- b) Discuss “debt makes a good situation better however a bad situation worse”, in relation to the M&M propositions I and II. (20 marks)

Part 3 (25 marks)

In the report to the board of directors of AfterPay, you are expected to:

- a) Discuss the scenario below, as to whether a riskless opportunity exists in the FX market and how to capitalise the opportunity.
- Suppose that you can borrow ¥21 million today. Assume that the current spot rate is ¥110/AUD and that the 6-month forward rate (Forward ¥/AUD) is Forward ¥/AUD = ¥107/AUD. The 12-month interest rate on a Yen deposit is 0.1% and on an AUD deposit is 7.5%. (5 marks)
- b) Discuss the advantages and disadvantages of derivative instruments. (10 marks)
- c) Explain why a put option on a bond is conceptually the same as a call option on interest rates. (10 marks)

TABLE 1. AFTERPAY PRO FORMA INCOME STATEMENT (in \$thousand)

	2020	2019
Sales	\$519,151	\$264,112
Variable Operating Costs	\$134,295	\$59,562
Gross Profit	\$384,856	\$204,550
Fixed Operating Costs	\$359,380	\$213,875
EBITDA	\$25,476	-\$9,325
Depreciation and Amotisation	\$30,035	\$22,371
EBIT	-\$4,559	-\$31,696
Interest	\$22,530	\$11,653
EBT	-\$27,089	-\$43,349
Taxes (30%)	\$3,925	-\$1,013
Net Income	-\$23,164	-\$44,362
Ordinary Dividends	\$0	\$0
Addition to Retained Earnings	-\$23,164	-\$44,362

TABLE 2. AFTERPAY PRO FORMA BALANCE SHEET (in \$thousand).

Assets	2020	2019	Liabilities and Equity	2020	2019
Cash and equivalents	\$606,041	\$231,456	Accounts Payable	\$180,730	\$109,981
Account Receivables	\$781,895	\$452,699			
Inventory	\$17,500	\$12,130	Total Current Liabilities	\$180,730	\$109,981
Total Current Assets	\$1,405,436	\$696,285	Long-term bonds	\$464,767	\$49,626
Net Plant and Equipment	\$125,023	\$67,516	Total Liabilities	\$645,497	\$159,607
Total Non-Current Assets	\$125,023	\$67,516	Ordinary Shares	\$975,317	\$674,769
			Retained Earnings	-\$90,355	-\$70,575
			Total Equity	\$884,962	\$604,194
Total Assets	\$1,530,459	\$763,801	Total Liabilities and Equity	\$1,530,459	\$763,801

TABLE 3. INDUSTRY RATIOS (Y2020)

	Y2020		
PROFITABILITY	1st Quartile	Median	3rd Quartile
Net Profit Margin	-29.36%	1.06%	11.79%
ROA	-16.58%	1.39%	8.26%
ROE	-34.32%	-0.10%	12.80%
ASSET MANAGEMENT			
Inventory Turnover	16.325	65.4	221.24
Days Sales Outstanding	31.53	52.325	66.81
Fixed Assets Turnover	0.69	1.13	1.93
Total Assets Turnover	0.36	0.6	0.81
LIQUIDITY			
Current Liquidity Ratio	1.16	1.73	2.24
Quick Liquidity Ratio	1.11	1.7	2.24
DEBT MANAGEMENT			
Debt Ratio	16%	50%	150%
Times Interest Earned (TIE)	-0.9	1.3	4.5
MARKET VALUE (<u>assume 281 million</u> shares and share price =\$70 - Moving Average of 50 days)			
P/E	-18.8	4.17	27.04
Market/Book	1.81	3.39	7.79