# Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

## On-line valuations

**15 June 2020**

Confirmation that the silliness is back came in the prospectus for the US listing of Lemonade last week, which reads more like an advert than a prospectus. The company claims to have "reimagined insurance from the ground up". It doesn't "use" technology - rather it "leverages technology, data, artificial intelligence, contemporary design and behavioural economics", managing a clean sweep of all the buzz words in the second sentence of the overview. This, it tells us, provides a "cocktail of delightful experience, aligned values, and great prices".

Which is useful, because it doesn't produce a profit, or very much revenue. Revenue was $67m in 2019 and the loss was more than the revenue at $108m. The company uses robots for customer communication. "Al Maya" is reportedly their "playful onboarding bot". While the claims bot "Al Jim" is not reported to be playful. This is fortunate because when the roof of your house has just fallen in, a playful bot may not be top of your wish list. The technology platform is termed the "blender", which is where I will place any desire to invest in this company.

### Bubble

It has taken a pandemic, recession, and social unrest to power NASDAQ to a new high last week, reaching 10,000 for the first time, rather like it took a bubble to get the Dow Jones index to 10,000 in March 1999. After the bubble burst in 2,000 the Dow Jones index took 3 years to get back to 10,000, though it was different stocks that were leading the charge then. In the same way as the 2000 technology bubble was fuelled by the interest rate cuts in 1998 in an overzealous response to the 1998 far east crisis, this bubble is also fuelled by interest rate cuts. When the tide changes, which it will at some point, we will see those that are swimming naked. So, it may be worth having a look at what is implied by the valuations of some of the online businesses in the UK.

### Models

The attraction of Lemonade relates to the recurring revenue streams. In insurance, customers tend to be very sticky. An insurance broker generally takes an upfront commission making broking revenue streams highly cash generative as well as having a high level of recurring revenues, which is highly attractive. That may help to explain why there are no quoted insurance brokers since JLT was taken over by Marsh MacLennan in 2018. By contrast the insurance underwriters are lowly valued by the market as they are capital intensive. A capital light, cash generative, recurring income is the holy grail. And Lemonade takes



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25% of the premium while laying the underwriting risk off to reinsurers, thus mimicking an online insurance broking model.

Thus, Lemonade was valued at $2bn at its last fund raise in April 2019 when it had just delivered $22m of revenue.

The principal for these online models to reach such lofty valuations is that it is possible to acquire a large number of customers quickly with online customer acquisition. If the lifetime value of a customer is above the customer acquisition cost, then that is a good case for investors to invest money in the company to enable it to reach scale quickly. The theory goes that the company can slow the marketing costs as it matures, enabling the embedded customer profitability to come through.

The issue for investors is that companies don't present their results with headlines saying "we acquired 50 customers at £20/head and got revenue of £50/head from which we make a margin of 30%. Instead they talk about growth. For example, Sosandar, the loss-making online retailer valued at £25m, doesn't disclose its marketing costs to acquire customers. Instead, it says, "revenue increased 53%" and "customer data base increased 76%". To interpret these results, it would be helpful if companies explained their models more clearly.

It may be useful to look at some of the existing online quoted online companies in this context.

## ASOS

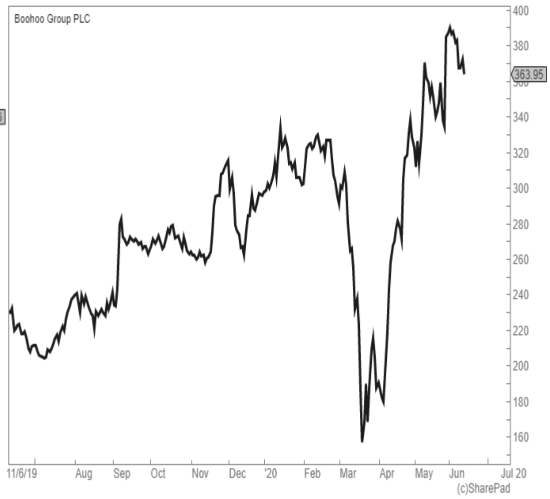
**Share Price** 2998p

**Mkt Cap** £2.99bn


## Boohoo

**Share Price** 370p

**Mkt Cap** £4.66bn




## Model

ASOS and Boohoo don't disclose long term value of a customer or its customer churn rate, so we need to make a number of assumptions to interpret the numbers. I will assume that customers are long term and the marketing spend equates to the cost of increasing the customer numbers each year.

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The table below shows that ASOS spends £63 on marketing to acquire a customer which is a lot more than Boohoo's £35. These figures are calculated by taking the marketing costs and dividing it by the growth in customer numbers for the last full year reported. An ASOS customer spends on average £134 which is more than Boohoo's £88. And ASOS captures 25% of that customer's revenue to contribute to its admin overheads and shareholders' profits, while Boohoo captures 14%. This margin is the operating margin before admin costs, calculated as gross margin less distribution and warehouse costs.

| | GM post dist'n cost | Acq'n cost | Rev/cust |
|---|---|---|---|
| | % | £ | £ |
| **ASOS** | 25.0% | 63.3 | 134 |
| **Boohoo** | 14.0% | 35.5 | 88.84 |

*Source: RNS*

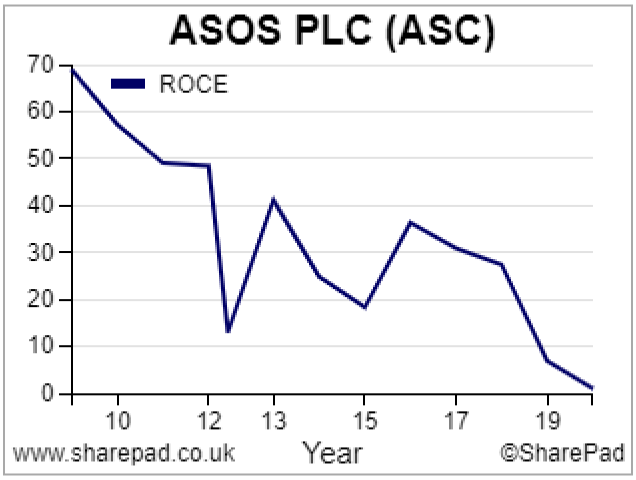
This implies that for ASOS £1 spent on marketing provides an incremental 52p towards overheads and profits per year, for as long as that customer remains a loyal customer. This is the revenue per customer multiplied by the contribution margin, so the profit contribution per customer divided by the acquisition cost, which comes out as 52%. The same calculation for Boohoo comes out at 35% meaning for every £1 spent on marketing Boohoo delivers 35p towards overheads and profits per year, for as long as that customer remains a loyal customer. That is good, but not quite as good as ASOS.

Looking at it another way we could say that ASOS takes just under 2 years to get its marketing money back while Boohoo takes just over 3 years. If it takes 2-3 years to get the marketing money back it perhaps may take 4-5 years to start to earn a respectable return on investment. I hope that customers are loyal to these online retailers for more than 4-5 years but with the majority of the customers aged 18-35 when life circumstances change rapidly, I don't know. Perhaps readers have a better view of that than me.

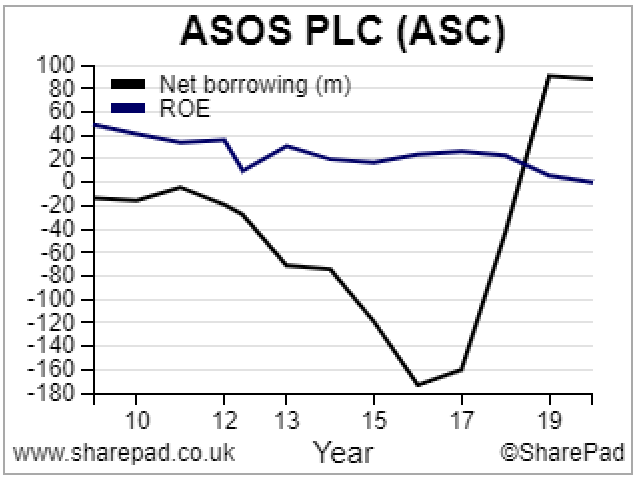
## ROCE changes

With such an efficient return on marketing spend for these companies as the model matures the inbuilt customer base would be expected to deliver a growing ROCE as the inbuilt customer base continues to order more goods without the need for more marketing spend. New customer acquisition therefore becomes a smaller part of the model as it matures delivering higher ROE.

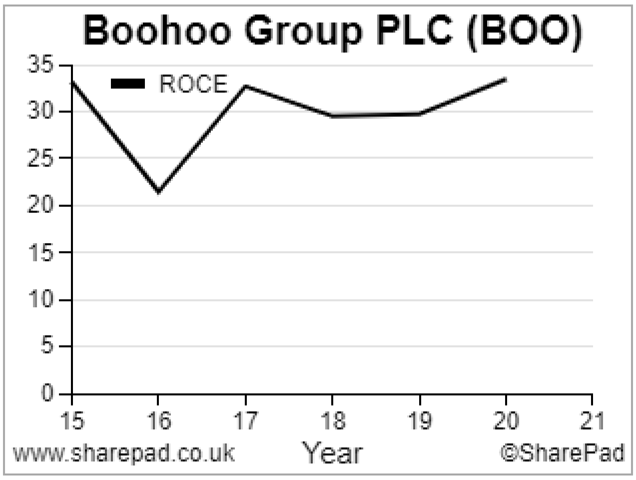
This is not the case with ASOS, where the warnings signs have been there since 2009




As a model matures with declining return on capital it suggests the model is tired. Cheap debt is often a useful way to enhance ROE when a business is tired, a path which ASOS has been trying to go down it seems.




Boohoo on the other hand has shown some modest increase in ROCE.

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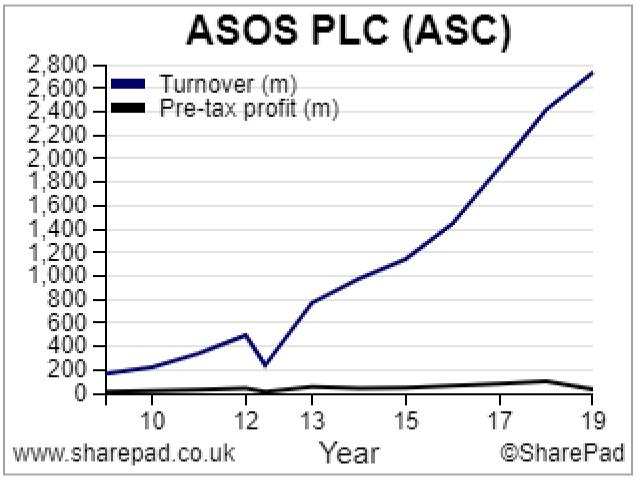
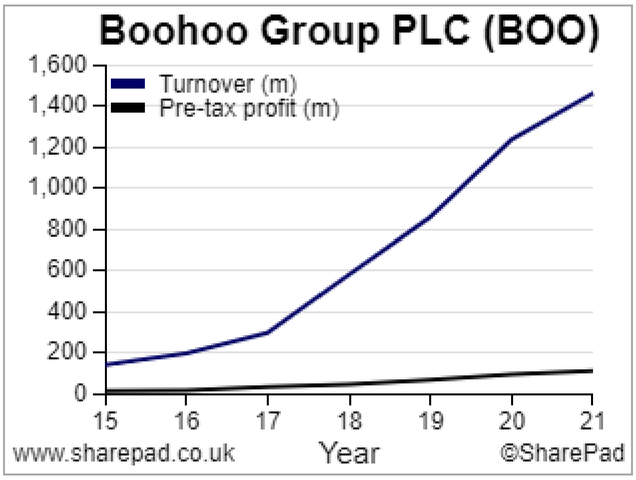
For both these two companies the evidence of increasing returns on capital as the business matures is underwhelming which casts doubt on the customers being very sticky. It seems that marketing spend may well be a constant requirement rather contradicting the theory that retiring marketing costs to allow the returns to accelerate is flawed for these companies.

The principle of high valuations of early stage online retailers looks flawed but not withstanding this Boohoo is achieving a high ROCE in the mid 30%’s. If this can grow by consistently re investing that cash the company should be a good investment.

## Growth

Companies largely discuss growth in their results commentary, which shows a far better picture than return on capital.




While ASOS’ return on capital has been in decline since 2009 it took until 2019 for the bolting on of revenue at ever lower returns to run out of road when PBT started to decline. The illusion of growth has been maintained at ASOS but with declining return on capital that growth has been vanity rather than sanity. Boohoo appears to have an intact profit generating machine.

## Valuation

**ASOS** trades at a high PE but only around 1X revenue which is growing. The ROE is expected to recover by 2022 to 13%. There are no signs that the underlying appeal of the business has been fixed that I can see and no reason to value this business highly as the market appears to be doing.

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## RATIOS

| Year | 2020 | 2021 | 2022 |
|---|---|---|---|
| PE | - | 60.0 | 37.1 |
| EV/EBIT | 471.4 | 44.5 | 28.6 |
| EV/EBITDA | 27.7 | 16.4 | 12.2 |
| Price to NAV | 4.6 | 4.3 | 3.7 |
| Price to free cash flow (equity) | -45.1 | 51.4 | 34.6 |
| EV/Turnover | 1.1 | 1.0 | 0.8 |
| FCF yield % | - | 1.6 | 2.4 |
| ROE % | -0.5 | 8.5 | 13.0 |

Boohoo trades at a lower PE but on account of its profitability that equates to a higher 2-3X revenue, while it is forecast to continue earning a strong ROE. Even in 2023 the PE multiple is lower than that of ASOS. If customers remain loyal to Boohoo this could be a good investment even though the valuation is somewhat forward looking.

## RATIOS

| Year | 2021 | 2022 | 2023 |
|---|---|---|---|
| PE | 54.3 | 38.3 | 29.1 |
| EV/EBIT | 40.5 | 29.2 | 23.4 |
| EV/EBITDA | 32.8 | 24.0 | 19.2 |
| Price to NAV | 7.2 | 6.1 | 5.0 |
| Price to free cash flow (equity) | 61.7 | 49.4 | 34.3 |
| EV/Turnover | 3.0 | 2.4 | 1.9 |
| FCF yield % | 1.5 | 1.9 | 2.7 |
| ROE % | 18.3 | 18.5 | 20.1 |

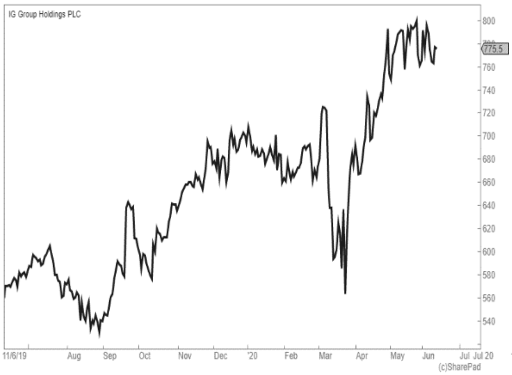
### CFD Providers

Spread betting customers on average lose money. For that reason, customers only last perhaps on average 2-3 years with a maximum duration of 5 years, but the return on marketing spend dynamics can be appraised in a similar manner.

## IG Group

**Share Price** 769p

**Mkt Cap** £2.84bn




## Plus 500

**Share Price** 1274p

**Mkt Cap** £1,350m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## Models

Each company discloses different metrics, so taking each in turn:

### IG Group

IG Group in its 2019 presentation believes that each new customer generates £8k of revenue over 5 years. Last year it spent £72.5m acquiring 67k customers so the cost of acquiring a customer is £924 which generates £8,000 over 5 years of which 54% drops into profit. This equates to a return on marketing spend over 5 years of 367% or a compound 36%.

| | Lifetime value £ | Period Years | New Clients No. '000 | Mktg Spend £m | Cost/Cust £ | Pre mktg. cost EBIT margin % | Over 5 yrs ROI | ROI p.a |
|---|---|---|---|---|---|---|---|---|
| IG Group | 8,000 | 5 | 67 | 72.5 | 924 | 54% | 367% | 36% |

### Plus 500

This company discloses its return on marketing for the historic years of 2015, 2016 and 2017. The 2015 cohort has returned 155% over 5 years, the 2016 cohort 130% over 4 years and the 2017 cohort 239% over 3 years. These are highly attractive returns on marketing, suggesting the stock market should be very happy to provide capital to accelerate growth, which would be evidenced by a high valuation.

| Year | Lifetime value £m | Period Years | Mktg Spend £m | Pre mktg. cost EBIT margin % | Over 3,4,5 yrs ROI % | ROI p.a |
|---|---|---|---|---|---|---|
| 2015 | 332 | 5 | 104 | 80% | 155% | 21% |
| 2016 | 360 | 4 | 125 | 80% | 130% | 23% |
| 2017 | 496 | 3 | 117 | 80% | 239% | 50% |

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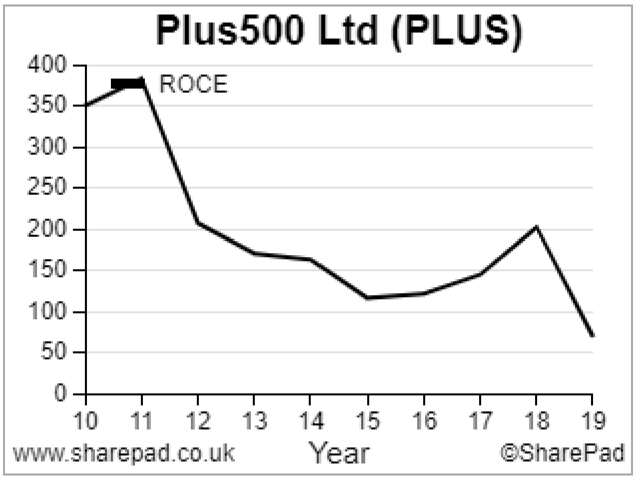
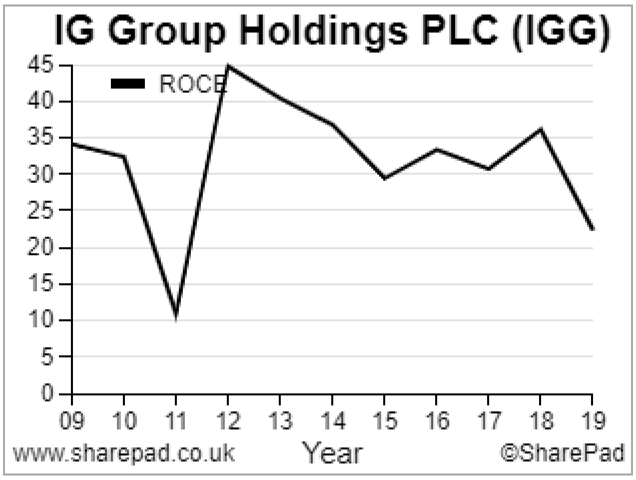
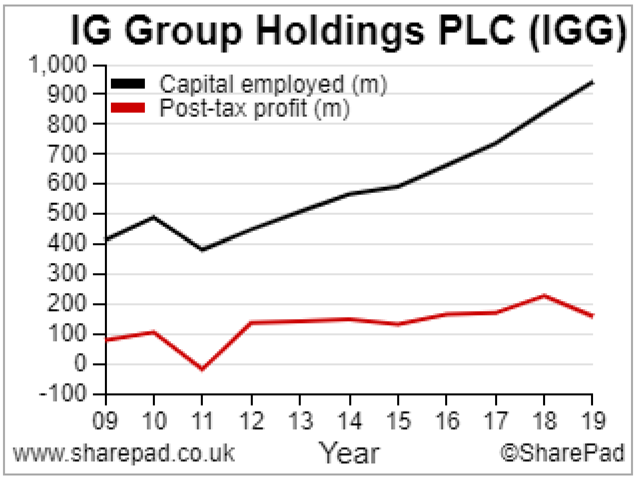
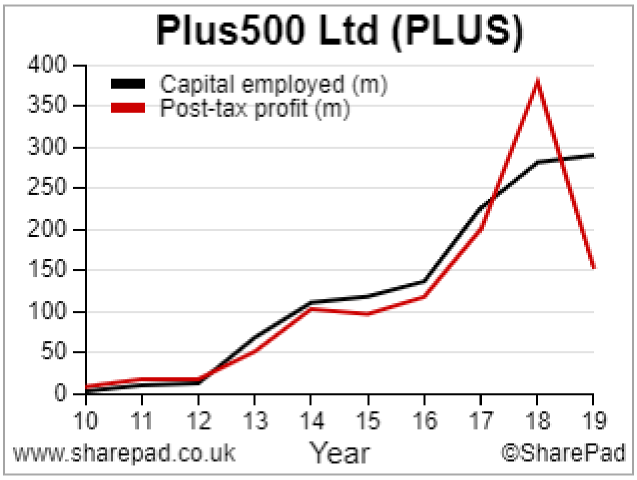
## ROCE Changes




Given the huge return on marketing spend these companies make it is surprising to see the declining ROCE. Both companies experience a profit decline on the back of changes in regulation last year, but it seems that IG Group has been building up its capital faster than its profits, while Plus 500 has kept capital and profits growing in tandem, paying out substantial special dividends and share buy backs to keep the balance sheet efficient. Perhaps there is some dividend upside to come from IG Group in the future?




## Valuation

These companies are undergoing a series of upgrades as lockdown is causing unprecedented volatility, resulting in strong new client sign ups. The companies have been quick to increase marketing spend. For that reason, the forecasts are downward sloping as analysts are reading this as an exceptional event. Therefore, the PE of IG Group increases from 11.9X to 15.4X going forward, while the PE of Plus 500 increases from 6.1 to 10.2.  My confidence that analysts are too gloomy is founded around the principle that a new client in year 1 typically produces a higher level of revenue in year 2.  In the short term the earnings are likely to be more volatile than valuations. But notwithstanding that the valuations are low in comparison to the online retailers.



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**IG Group**

RATIOS

| Year | 2020 | 2021 | 2022 |
| --- | --- | --- | --- |
| PE | 11.8 | 15.4 | 14.1 |
| EV/EBIT | 8.6 | 11.3 | 10.5 |
| EV/EBITDA | 8.1 | 10.6 | 9.5 |
| Price to NAV | - | - | - |
| Price to free cash flow (equity) | 15.2 | 12.7 | 15.3 |
| EV/Turnover | 4.0 | 4.6 | 4.3 |
| FCF yield % | 6.6 | 7.9 | 6.5 |
| ROE % | 29.1 | - | - |

**Plus 500**

RATIOS

| Year | 2020 | 2021 | 2022 |
| --- | --- | --- | --- |
| PE | 6.2 | 10.3 | 10.7 |
| EV/EBIT | 4.1 | 7.7 | 8.0 |
| EV/EBITDA | 4.1 | 6.9 | 7.3 |
| Price to NAV | - | - | - |
| Price to free cash flow (equity) | 3.9 | 9.6 | 11.3 |
| EV/Turnover | 3.8 | 3.6 | 3.7 |
| FCF yield % | 27.2 | 11.1 | 9.4 |
| ROE % | 95.3 | - | - |

### Conclusion

While the return on capital for the spread betters is between 20% and 150% and their returns on marketing are between 21% and 50% their valuations vary from 6X to 15X PE. Conversely in the retail space ASOS earns a small ROE and Boohoo is approaching 30%. The returns on marketing are similarly healthy at 35% or 52%, but the valuations are 30X and 37X PE looking out to 2022. For that reason, I don't own online retailers, rather I own IG Group.

## Summary

The value of on-line businesses depends entirely on customer stickiness. Lemonade, coming to market in the US at a high valuation hasn't proven the stickiness of its customers and the valuation would appear to be assuming a very long-term customer. The valuations of online retailers similarly assume a very long-term customer, though ASOS' performance indicates this is not the case. The online spread-betters actually tell us their customers last a maximum of five years and the market provides a discounted valuation accordingly. But the high return business models of these companies imply investors will earn a good return by investing at modest valuations.

## Future Events

| Company | Date | Event |
|---|---|---|
| Boohoo | 19-Jun | AGM |
| IG Group | 23-Jul | FY Results |
| Plus 500 | 13-Aug | H1 Results |
| ASOS | 16-Oct | FY Results |

*Source: Sharepad*

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