

A study in scalability and how it can drive strong investment returns

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We have noted of late, increased commentary about particular ASX listed companies that are perceived to be expensive on traditional measures - without regard for their actual business models. In this Insights article, we specifically discuss companies using 'scalable business models', define what this term means, and outline two examples.

In its simplest definition, a scalable business model **increases profits over time by growing revenue while mitigating a proportionate increase in costs.**

Scalable businesses can grow exponentially due to a range of factors, including but not restricted to: low capital intensity and human capital requirements, quick and low cost deployment, fast iteration of product and business processes to fulfill customer needs.

We generally find scalable business models in industry segments such as software, online travel agents, digital finance and goods, and online advertisements.

Scalability: Key elements and drivers

We consider the key elements of a scalable business model to be:

- A disconnect between sales growth and cost growth
- The removal of capacity constraints by collaboration via partnerships, creating platforms and capital efficiencies
- Generally based on intangible assets like intellectual property (IP) such as patents, software, data etc. These typically have minimal replication costs while being able to realise full value from the asset.
- Uses technology as a lever - for example, the advent of recorded music did not require a musician to be on site to listen to music
- Utilises existing infrastructure - Whatsapp at the time of acquisition by Facebook had only had 35 engineers servicing 450 million users. Today has around 50 engineers servicing over 1 billion users. Its adoption was driven by the rise in smartphones and cheap, mobile internet access.

The scalability of a business model we consider to be driven by the following factors:

Concept - Inputs

- Technology - the automation of processes, scalability of technical infrastructure used in the delivery of the product or service
- Cost and Revenue Structures
- The ability to adapt to different legal environments and execute

- Network effects - defining and achieving critical mass and virality amongst the customer base
- User experience - solves a customer problem, simplicity in the offering, knowledge of and by existing users
- Scalable revenue streams: Ecosystem, reoccurring revenue streams, network effects - increase in revenue corresponds to an increase in margins

Realization - Output

- Management: ability of the team, location, partnerships
- Market: potential, dynamics, awareness
- Investor attractiveness and valuation
- Company growth

Two examples of scalable ASX businesses

A couple of ASX listed companies that we consider to possess scalable business models are **Altium** and **Afterpay**. Both operate and are leaders in 'winner takes all' markets, possess novel products and intellectual property, as well as holding customer-centric visions of the future.

Altium is a software company whose software assists in the design of electronic components critical to the operation of the technology that is ubiquitous today. In 2012, company revenue was \$55 million and the EBITDA margin was only 0.5%. By 2018 the company had grown to revenues of \$140 million and had achieved an EBITDA margin of 32%; with consistent increases in both revenues and EBITDA margins year on year. To me, this typifies a scalable business model.

Afterpay is a payment solution platform, that has been growing extremely fast over the past couple of years driven by consumer and merchant demand. We feel the company has just reached its tipping point, in the 2018 financial year gross sales were achieved of \$2.2 billion, while its EBITDA margin was circa 1.6%. We believe the company can achieve gross sales of \$10 billion within 2 years, whilst increasing its EBITDA margin to close to 3% or circa \$300 million.

Summary

Investing in scalable businesses is an attractive proposition, and can lead to outsized returns over time. Investors should keep in mind however that investing in a scalable business is not a panacea as they can be disrupted themselves and are subject to market forces just like all other businesses.

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