The investment case for EML just got stronger

18 November 2019 | Dominic Rose, Montgomery Investment Management

EML Payments (ASX:EML), an Australian FinTech that specialises in digital gift cards and pre-paid cards, is a core holding in the Montgomery Small Companies Fund. Making EML even more compelling is the recent transformational acquisition of Prepaid Financial Services.

The acquisition of Prepaid Financial Services significantly strengthens the investment case in our view, increasing Group exposure to the fast-growing prepaid card market whilst also adding an exciting new vertical to the structural growth story in European neo-banking.

The company also issued solid FY20 earnings guidance (29-43 per cent EBITDA growth) at its Annual General Meeting and subsequently held a well-attended investor day ('EMLCON') showcasing the depth and breadth of the underlying business with positive endorsements provided by numerous program partners.

EML is a FinTech company which provides critical technology infrastructure for mobile, virtual and physical gift and reloadable prepaid cards for corporate clients across Australia, Europe and North America. The company has strategically targeted large and growing industry verticals requiring innovative and customised payment solutions, such as salary packaging, shopping mall gift cards, gaming and wagering, and consumer lending. It is important to note that EML in not a financier nor a funder, rather it is an outsourced payments solutions provider to corporate partners.

In what will represent its largest ever deal, EML has agreed to acquire Prepaid Financial Services (PFS) for an upfront consideration of £226 million (A$423 million) plus an earn-out of up to £55 million (A$103 million). The acquisition has been funded through an A$183 million entitlement offer (priced at $3.55 per share), a A$67 million institutional placement (at $3.55 per share), the issuance of A$77 million worth of EML shares to the PFS vendors ($3.55 per share, escrowed until the release of FY20 results) and a new A$175 million debt facility which will initially be drawn to $100 million.

Established in 2008 and based out of Ireland, PFS is a privately-owned and founder-led prepaid cards and payments technology specialist in the UK and Europe. PFS describes itself as a leading provider of white label payments and Banking-as-a-Service Technology. What does this actually mean? PFS basically provides similar payments technology solutions to EML, however PFS is focused on the financial services sector, specifically the rapidly emerging European neo-banking segment. EML does not currently operate in this niche space simply because it has not built out the required technology and PFS is such a dominant force.

PFS' competitive advantage relates to its leading-edge technology. The company has developed an innovative prepaid payment technology platform which enables its clients to efficiently deliver digital banking and payment services to their end customers without necessarily having to become a regulated entity themselves. The product offering encompasses reloadable prepaid cards, virtual cards, multi-currency cards and business prepaid cards. PFS' client base spans blue-chip financial institutions, non-

financial corporates, SMEs, FinTechs, governments and NGOs. Examples include Spanish neo-bank Rebellion, Spanish postal service Correos, Slovenian bank NLB, the United Nations Refugee Agency, the Red Cross and the UK Government.

Impressively, the PFS business has evolved to become one of Europe's fastest growing FinTechs (33 per cent compound annual revenue growth over FY16-19) with operations in 24 countries and FY20 projected annual processing volumes of around A$5 billion. Similar to EML, PFS has a scalable business model and is highly profitable; PFS is expected to generate FY20 EBITDA of A$24 million (pre-synergies) which equates to about 60 per cent of EML's existing earnings base.

The rationale for the acquisition makes strong strategic sense to us. The transformational deal consolidates EML's market position as one of the largest independent FinTech enablers in digital banking and prepaid cards globally. PFS adds material scale to the Group, with processing value ('GDV') increasing by almost 40 per cent to A$18 billion in FY20, while the deeper European presence will likely deliver both operating leverage and synergies benefits.

The deal also broadens the existing solution suite with the addition of new solutions in digital banking and multi-currency offerings, areas where EML previously lacked technical expertise. Neo-banking is a particularly exciting emerging growth sector where new digital entrants are disrupting incumbent banks thanks to better technology offerings and superior client service. EML sees opportunities to cross-sell PFS' digital banking and multi-currency offerings into its global market footprint, particularly in the US which is a large and under-penetrated market. These cross-sell opportunities are not factored into the deal guidance, rather remain as further upside potential.

Other benefits of the deal include customer and geographic diversification, as well as a mix shift towards the faster growing reloadable card segment (reloadable increases from 25 per cent to 54 per cent of pro forma FY19 revenue). We also like the strong alignment with the PFS founders who are staying on to run the business, are incentivised with an earn-out component and they have taken a substantial amount of EML stock as consideration.

While the headline multiple of 17.5x FY20 EBITDA appears relatively full, this reduces to 14x including targeted annual synergies of A$6 million which look conservative. We think 14x is a reasonable price to pay for a highly complementary and fast growing Fintech with significant upside potential.

The deal is materially earnings accretive for EML, greater than 25 per cent on a FY20 pro forma basis including synergies. Looking at the way broker consensus earnings estimates have been cast post deal, we think they are overly conservative and imply a material slowdown in the existing business over the coming years which we view as highly unlikely. That said, we are happy for the company to have substantial headroom to beat market expectations. We also expect the balance sheet to de-lever quickly, returning to a net cash position with two years based on our forecasts.

EML is a great example of the kind of structural growth companies that the Montgomery Small Companies Fund is looking to uncover – a well-managed, innovative company using its technological advantage to execute on a multi-faceted growth strategy and which enjoys a highly cash generative business model delivering strong and improving returns on capital. Our job is simple – find more of these!

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The Montgomery Small Companies Fund own shares in EML Payments. This article was prepared 18 November with the information we have today, and our view may change. It does not constitute formal advice or professional investment advice. If you wish to trade EML Payments you should seek financial advice.

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