Affirm Holdings, Inc. NasdaqGS:AFRM

# Affirm Fireside Chat with Wells Fargo

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# Call Participants

EXECUTIVES

Michael A. Linford
Chief Financial Officer

ANALYSTS

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

# Presentation

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

Maybe if we just begin with last quarter. I mean, it feels like the holiday shopping season is kind of like so far in the rearview. But it would be really great to just discuss that momentum that you carried out of the quarter, I mean, 32% GMV growth continues to be strong and above your medium-term targets and revenue growth at 48% is a really impressive way to end calendar 2023.

Michael A. Linford
Chief Financial Officer

Yes. We feel like we had a really good quarter. We were able to grow GMV at a very healthy clip. We grew revenue faster than GMV and our unit economics, the revenue less transaction cost, the transaction economics were really strong, solidly in our 3% to 4% long-term guidance. And I think that's a reflection of a lot of the hard work the team put in over the past 12 and 18 months.
As you know, we've been navigating through a lot of volatility in the macro, the last quarter showed what happened when this team gets focused. Max really hit it in the letter, and we encourage all investors to take a read on it, but we were a really focused team, and that focus showed up with really excellent execution and really, I think, surprising a lot of folks around our ability to execute in any macro environment.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

Great. So I just want to start with a broad retail investor question to help kick off the conversation at a high level. Adam W asked, what would your pitch to a potential new investor in Affirm stock be?

Michael A. Linford
Chief Financial Officer

Yes. Maybe I can just explain why I'm still here and why I think this opportunity for us ahead is so large. I think we're going to be the winner in a very big market. The market that's being created right now, is being created in a way that we think is quite inevitable as consumers move away from traditional ways to pay and access credit and move towards safer and better products. That trend is, we think, very long term and very permanent.

Right now, we're in the early innings of it with the move towards BNPL as a payment option in channels like e-commerce with off-line commerce and further penetration in e-commerce remaining. And we have the best mousetrap in the industry. Our ability to create the right outcomes from a credit perspective to delight consumers and drive merchant conversion for them is really differentiated and really unmatched by any of our competition. So we think we have the best mousetrap in a very big market with real moats.

Very few players can do what we do on credit. That's really been on full display over the past 12 months and our capabilities with technology enable us to partner with the world's largest enterprises. And so when you sum all that up, we've got a market-leading position in a very big market that's very high growth, and that really says to me that we have a ton of opportunity still ahead of us.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

So not only you're able to differentiate yourself from the traditional consumer lenders but also within the BNPL space, you have that sophistication that really hasn't been matched and we think, particularly on the funding side of the house as well.

Michael A. Linford
Chief Financial Officer

Yes, I think our capital -- these things are all connected. So our ability to execute well on credit creates opportunities in the capital markets, which allow us to grow quicker. And these things are all linked together. And again, when we're executing well like we are right now, you see the machine generate real momentum, and that's what you saw last quarter and it's what we're focused on continuing to drive.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

So maybe if we just talk about the customer dynamics here. I mean now you've topped this last quarter at 17 million consumers. Obviously, in the grand scheme that has a long runway to go. But maybe if we could just kind of understand like when you do add a new customer, what do the -- like retention or churn curves kind of look like as far as the life cycle of a new Affirm BNPL user?

Michael A. Linford
Chief Financial Officer

Yes. I think it's important to think about merchant and consumer both when we think about retention and churn, the dynamics of the business. Today, we acquire almost all of our users at the point of sale on our merchant sites. And so merchant retention and engagement is super important. And we're really proud of the data that we have there. At the Investor Forum in November, we talked about our net retention rate on merchants as being 115%, which means that on balance, the merchants are growing and any sort of churn that's happening is less in the growth in the underlying merchant base, which is very important for us because that allows us to continue to see more users.

On the consumer side, we've actually transacted with over 40 million consumers over the lifetime of Affirm, 17 million number that you mentioned is those who have taken out a transaction in the past 12 months. If you expand that 12-month window just a little bit and you think about an 18- or a 20-month window, the number goes up quite substantially. And so we think about the opportunity for us in driving more frequency and more engagement is one of the key ways we're going to grow that the annual actives as users who are maybe engaging with the platform every 18 months can move to be an engaging every 12 months. And we're really proud of the progress that we've made there.

If you look at the transactions per user, you see pretty healthy growth in engagement on the platform over the past 12 months. Again, I think that's a combination of the strong distribution that we have. We partnered with the world's largest enterprises, but also the product set that we have, where in this environment, in this macro environment, we're able to serve a lot more transaction types than really anybody else.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

And maybe if I could just double click on that. The 17 within the 40 is a really interesting way to kind of paint a picture around what the immediately addressable kind of touch points are with those who are already familiar with the brand. But maybe if you could give us like some general characteristics of like who ends up being retained? And like what's the type of consumer that ultimately churns over time? And how do you kind of think about that?

Michael A. Linford
Chief Financial Officer

Well, one of the things I talk a lot about is just how really incredible our brand is and its ability to span really all income credit segments, purchase modes, et cetera. We have a brand that works with the general merchandise categories, some of the world's largest value-oriented retailers while still serving premium luxury brands. And I think there's a real insight there around we're solving a problem that I think is truly a universal problem – it is credit writ large. It's not credit in any one microsegment. It's not credit in any one purchase modality. It's a very broad, very cross segmented user base.

And so one of the stats we put in, for example, into our last ABS deal was the average FICO was around 660. And that's really right down the middle with respect to the U.S. consumer. If you think about what we do, what we do matters to people who are FICO 720s and FICO 600s. And I think the ability to span the applicability of our product set is really impressive, and again, very differentiated. A lot of credit card companies can do half of that on one side and a lot of BNPL companies can do the half on the other side. We're one of the few players who can really span the whole gamut.

Why that's so important is, I don't think there's really a constraint in the profile or demographics of the user that we serve. We serve all ages, all income segments, all credit segments. And so I think there's a really broad base way to engage those users. I think we think about things like distribution as being very important for giving consumers more opportunities to engage with us. Consumers love finding us on their favorite retailer sites. And I think the more distribution we have, obviously, the more they can see us and engage with us.

Part of the reason we're so excited about the card is it really does unlock a whole lot of opportunities for consumers to continue to repeat with Affirm, even if it isn't a way for new users to find us yet, it is absolutely a great way for them to repeat. And so broad-based user segments, broad-based merchant distribution helps us drive better retention. And I think that the thing that's maybe most common about users who end up repeating often on Affirm is that they're really good risk because those who aren't, obviously, if you charge off, you're not eligible for their engagement on the platform. And so us finding really good risk and finding users who know how to use credit the right way, is probably the most important factor for determining what we think is the highest value users in our platform.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

And a quick follow-up to that. I mean -- what do you think is harder, getting that Affirm, the new Affirm user to transact the first time or getting that user who used it one time to use it the second time.

Michael A. Linford
Chief Financial Officer

That's an excellent question. I think it's harder to get that first use because it's totally brand-new, but there's just as much value in us thinking about the first to second and second to third transactions, again, specifically in the context of the card. Getting the card is not enough. We need to get the card and get the user to engage on the card. And so a lot of our effort in product work right now is about making sure the user experience is good enough so that users, both attempt to use it and then want to repeat it. And that's how they really begin to understand the product. So much of what Affirm is really does require use to really understand -- it's a product that's new and different and sometimes using different modalities Pay-in-4, for example, or interest-bearing monthly installment loans, is important to really understand how widely you can use it.

But once users do get through that, they understand what it is that we do, they understand how it works, they become very, very active. And our most active consumers obviously really are using our payment tools as the primary ways to pay and plan for their larger purchases. And that's the best spot to get to. But I think we talk a lot about how that may not be for everybody. And our job isn't to try to make every user that but make sure that the experiences are set up so that those users who do want to engage that way can.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

You mentioned Affirm Card multiple times, and it's a product that we've been excited about for a very long time now. And it's now that it's officially being launched out of beta, you're seeing that traction in the curve that you put in the shareholder letter, 800,000 consumers, $400 million of GMV last quarter. Obviously, initial traction has been strong. I mean how has this traction kind of progressed relative to your expectations even just like 6 to 9 months ago?

Michael A. Linford
Chief Financial Officer

I think we're very early. And so part of the reason we've been careful to talk about things like forecast and longer-term expectations here is because we're humble enough to know that we don't have all the answers yet. It's early innings here, and we're beginning to figure out how resonant this product is. We remain super excited about it though. I think it's probably the most valuable thing that Affirm is working on right now, mostly because it solves a key pain point in those repeat usage modes we talked about, which is -- when you're shopping online, our experience is delightful. It really is an awesome experience that we can deliver for consumers.

When you're shopping off-line, there's a lot more friction that gets introduced. And our product without a physical card is less delightful. And I think the new thing about the card is it really does solve about last mile, I think, quite well. So I remain very, very excited about it, but it's super early. We have about 700,000 cards as of our last quarter. We're adding about 75,000 a month. I think the surprising things to me is how consistent the product has been since we started ramping it, both in terms of the users that we're adding on a monthly basis. That line that we put in the chart is exceptionally flat. And I think it shows you just kind of the natural rate of user growth in the business right now. And the spend per user has been consistent as well.

I think the thing that we have been really impressed with is the fact that as we started from our most active and excited Affirm consumers and expanded the offering to more and more people on the platform. We would have expected some level of spend per user compression, and that hasn't happened. And I think that's a really good testament to some fundamentals about why that product is so valuable to these users. And it's really serving that Affirm experience in a form factor that is useful offline and online. It's useful for pay now and pay over time and expanding the number of times the consumer can use, our product is so valuable to us.

And so I think it's been impressive, it's been consistent as it's continued to scale, although it is very early. And so I think that may not always be the case. But for right now, it's pretty impressive how consistent it has been.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

And maybe if you could just specify a little bit, the unique trends and different types of usage you're seeing from the Affirm Card users and the non Affirm Card base, they're consistent. Is that the right way to you're really not seeing too much divergence there?

Michael A. Linford
Chief Financial Officer

Yes. I think the thing that's most impressive is the spend per card user has really been very consistent from early adopters all the way through the current adopters. And the real growth in the card hasn't been growing share of wallet for the same users. So it's actually just been further distribution of the card. And why it’s so impressive again is that we started with our most exciting customers. And so you would have assumed that the last user through the door has been a little bit less engaged and it hasn't really proved out yet which tells me we're still very early and there's probably a long road to hoe here.

But I think if you think about that difference between the Affirm user broadly and the Affirm debit user, the Affirm Card user, the biggest difference is just level of engagement. So Affirm Card users are far more engaged on the platform, more than quadrupling the amount of engagement that we see on a transaction count basis, much healthier mix of online and off-line transaction counts where folks are actually able to get and use the product offline more effectively. But with one commonality, which is that they are printing profitable units for us, meaning that we're able to generate good and strong unit economics, whether or not they're buying through the card or through the online integrations that we have.

And I think the recipe for success for us is keep these users who want to engage with us, able to engage on the card, drive that extra frequency with transactions that look like the rest of what we do every day. And the idea for the card really dates itself back to when we had -- still do have a very large direct-to-consumer business, where we're issuing virtual cards. And what we've really done has been able to transition those more frictionful experiences into a lower friction experience for consumers and the increased engagement that you see out of that is why I think we've been able to show so much growth early.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

Yes. I mean you mentioned the in-store and that for e-commerce provider, payment providers in the past, it's always proven a very difficult paradigm to cross. And anecdotally, I was at Walmart yesterday, and I saw the little Affirm tag post up on the checkout. But -- maybe if you can just talk through the incremental initiatives that you guys have rolled out over the last couple of years that we should be considering and what can drive that further engagement and spend in store? I know last quarter, I think you highlighted that 30% of GMV on the Affirm Card was in store, if I'm not mistaken. And -- just how you kind of see that physical point-of-sale kind of evolving?

Michael A. Linford
Chief Financial Officer

Yes. I think it's very much an unsolved problem for the industry writ large. I think you hit it quite well. I think most people who do digital payments of any kind have had a hard time making it work off-line effectively. And a lot of reasons for that, but your anecdote, I think, is quite salient, which is when you're in a large multi-lane checkout environment, doing anything that requires fumbling with your phone and the like is just -- it's a pretty high stress user experience.

I would like to talk about why a lot of loyalty programs at grocery, for example, allow you to just type in your phone number. And they do that because if they require that you are scanning a barcode on your phone or doing any of that sort of higher touch stuff, it would create the wrong user experience at a moment, that’s already quite stressful, which is that you're checking out in a big kind of chaotic environment. And I think what is so important about that is like when you're shopping online, it's super easy to go your own pace and you're not worried about the 2 kids in the cart next to you, you're just getting through the transaction at your own pace.

When you get in the physical store, there's a lot of other things going on. And so the experience really does need to be even more delightful, lower friction. And the observation that we have is that a physical card is probably the best way to do that. Now I think a lot of companies have had resistance to the idea of using a physical card complying with a digital payment method like this. And I think that's the unique thing that we've been able to do is we bring that Affirm Digital credit experience to a physical card. And that's definitely the most important thing that we're working on with respect to scaling off-line usage.

But the problem is not limited to just that. I mean, obviously, that works for people who are highly engaged in the platform. There's a lot of work we're still doing on making sure that our experience in wallets, digital wallets is great. So tap-to-pay can work for Affirm loans, whether you've got a physical card or not. And as you mentioned, some of our partners are beginning to experiment with physical self-checkout type experience. And those are really great ways to keep chipping away at it.

But I think I've said this before, and I'll keep repeating it out. We're very humbled by this opportunity. It's very hard. This is not a solved problem. And I don't think that we think that we have it all figured out just yet. There's a lot of work for us to do. But the price is huge. As important as e-commerce is and as growthful as it is, it's still dwarfed by the size of offline commerce and addressing those off-line purchase modalities is an enormous price for us when we're able to solve it.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

Obviously, your ambitions longer term are not just limited to the Affirm Card. And obviously, things like the Affirm account savings, you continue to roll out -- maybe if you could just kind of think from a higher level, like how do these things all kind of marry in? Is it just kind of -- just further embedding Affirm into the consumer's financial life? And how can you really think about that in a more cogent way.

Michael A. Linford
Chief Financial Officer

Yes. I'm not sure I can be more cogent, but -- the way I think about it is -- our mission is just incredibly ambitious. Our mission is not helping consumers transact efficiently. That is something we do, but it's not our mission. The core of our mission is to build honest financial products that improve lives. And we know that when we do that, we can do it profitably in a way that's good for the consumer, the merchant, ourselves, our shareholders. And so we're really uninhibited here. We have a really big, ambitious mission, which is to improve lives and the scope of that is honest financial products. Where we have started is thinking about ways in which consumers purchase things and typically larger considered purchases. I think as we continue to evolve with the Affirm Card, we're trying to expand the kinds of purchases that we can serve.

But even that, as you mentioned, is only a subset of people's financial lives. And I would say that so much of the bigger ambition after you get out of purchases is very down the road for us. We're very focused. And I think I'm very pleased with how focused we are right now on the shorter-term opportunities. But longer term, we do continue to have a vision around building honest financial products. And I think that the Affirm Money account is a small window into the potential into the future.

I think it's -- I'm an Affirm money account user, it's my primary payment method with the -- coupled with the Affirm Card. I think it's a great experience, but it's also not an experience that we expect everybody to be at just yet. And so we think a lot about it as not even -- as being able to meet the consumers wherever they are. So if you want to use Affirm just online and just for the largest considered purchases, we want to make sure we do that experience really well. And as consumers want to engage more with us, we want to give them chances to do that. And the Affirm Money account is a really good way for us to do some of that. But obviously, it's still, I think, tip of the iceberg, there's a lot underneath the surface here.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

I mean, so whatever you can share from a product development standpoint, what exactly are you kind of working on behind the scenes right now that you've spoken to from a product road map on the next, say, 12 to 18 months? Is it closing the gaps on some of those products that you just recently rolled out? Is it making those more sophisticated? Is it something like additional adjacencies. But how should we be thinking about it?

Michael A. Linford
Chief Financial Officer

Yes. I think we're still really early in so much of what we've built already. And so there's a lot of work we get to do on the stuff that's kind of on our plate right now. One of the stats last quarter that I was just most impressed with is some of our longer live partnerships we're showing the highest growth. Our partnership with Shopify grew at over twice our total company GMV growth rate in Q2. And that's a partnership that we started talking about in the summer of 2020.

And so for a business to be as "mature" meaning number of years live on Affirm as that relationship is to be growing that quickly is a really good indicator for just how much opportunity we have ahead of us because we're so early in the basic adoption of the category overall. And so whether it's with our existing largest enterprise partners, or continuing to find new partners and new distribution, we feel like there's a lot to do kind of in the core business. And that's why we talked about at the investor forum as the majority of our growth over the next 3 to 5 years really is going to come from what we call winning at checkout, which is doing the same thing that we do and just continuing to scale that. And there's a lot there. There's a lot of valuable work to do. There's a lot of shareholder value creation we think we can drive. And just staying focused on that core piece of our business.

The things that we think layer on top are the Affirm Card, as we talked about, continue to be very excited about its long-term prospects. But given its low size as a starting point, I think in the next several years, it's still not going to be the majority of our business. And then we have some more strategic bets going on and expanding the -- expanding what we do geographically and from a consumer standpoint. So we added B2B sole props into the mix, and we're adding new geographies.

Those aren't going to be super big contributors in the near term. We've talked about them as being still smaller than even the card and obviously a lot smaller than winning at check out in the core markets. But importantly, strategically, we know we need to get those additional geographies and potential users into the system now and begin working on those problems because in three and five years, it'll matter a lot more.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

To that end, we had a question come in. On the international front, Skyler RS. So how is the international expansion going? And any rough estimates for revenue growth there over the next few quarters and/or years? I think you've said a couple of points from a GMV growth perspective, but maybe if you can just kind of fill out the rest.

Michael A. Linford
Chief Financial Officer

Yes, launching new markets for us is something that's very hard and it's something we take with a lot of thoughtful approach and planning. We've been very intentional about where and how we enter new markets. And we've communicated that we want to be in the U.K. this calendar year, and we remain committed to doing that. But again, I think it's important to know that the value of these new markets is not going to be the next 12 months that they're not going to show up in the P&L in a super compelling way in 12 months. These things really do take some time to see. And so -- we think about it as important to get there and begin working on the problem much more so than some sort of big overnight push.

And that being said, we've been very pleased with the quality of the merchant conversations we've been having in some of our new markets. I think what we do is different and unique. And when we can talk to merchants who aren't able to access the kind of products that we can bring to market, and we can show it to them. I think there's a lot of excitement for what we can do as we enter new markets. And so I think investor -- or merchant appetite, merchant interest is really, really high. And I think we can continue to plant some seeds early with those merchant partners, and we're confident they'll grow into pretty big trees down the road.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

And forgive me for being short-term oriented, but any kind of initial changes in your views around that from what we knew in November at that New York Investor Day. What you've seen today?

Michael A. Linford
Chief Financial Officer

No. Again, I think we're very thoughtful and being very intentional about it. I think the thing that I'm most excited about is just the level of merchant and partner demand and excitement for us entering these new regions. And that's true for existing partners who I think do want to take us there, but also for new partners. I think it's a good reminder to ourselves just how different our product solution set really is. I think a lot of folks want to just group it into the easy buckets of things. And the truth is there's very few people who do the kind of work that we do. And that's just because it's really hard. It's -- everything that we do is not easy to pull off. And I think the ability for us to do that is something merchants get really, really excited about. So I think that's the only minor update. But yes, no, I think the right timeline to think about for international is measured in years, certainly not months.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

And if I could just a quick follow-up. Is there a different like competitive environment in international versus the U.S. which we should be contemplating?

Michael A. Linford
Chief Financial Officer

Yes, definitely. In the U.S., we'd estimate that we're a pretty strong market-leading position, both in terms of the GMV we process on the platform, but also the monetization side, so on the revenue side, for sure. And so we have that position of strength. We partner with the world's largest enterprises. We partner at scale, and we have, we think, is the most valuable network.

When we enter a new market, we have none of that. We're really starting from ground zero, and very few of these markets have -- are lacking some existing players. And so we think about our opportunity to go into some of these new markets as a chance to be somewhat disruptive to the incumbents. And that's a good position for us to be in because, again, I think the merchants really do get excited about what our product can do for them. And I think that sometimes the lack of options in some of those markets creates some dynamics that merchants don't love. And so us coming along, I think, is pretty well received.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

And seeing something new is kind of exciting. I had a question come in from Oren A. What do you think about Affirm having loyalty and quick pay reward options for users who pay faster. Broadly speaking, can you speak about -- speak to Affirm's plans for potential reward programs and what impact they might have on unit economic margins over time?

Michael A. Linford
Chief Financial Officer

It's a great question. And much like with what we have in our off-line approach, I'd say we're pretty humbled with the fact that we don't actually have all of the answers figured out yet. But we do know that driving some kind of loyalty or rewards ecosystem is going to be important for us. I think that's especially true with the card, but it's true more broadly. I think we know that that's a thing that we need to continue to work on.

Right now, our unit economics, which we measure with this revenue less transaction costs as a percentage of GMV. We talked about that as being 3% to 4%. And despite the fact that we're in a very high rate environment, we're really doing excellent there where we're right in the middle of that 3% to 4% range, and we feel like we can drive sustainable long-term growth staying inside of that range. And that does give us the ability to think about where and how we would invest, but we would never do so in a way that takes us away from that 3% to 4% commitment that we've made.

I think the early pay or quick pay concept is very interesting. I think that we believe that our credit outcomes are really excellent as they are. And so we don't think we need to incentivize users to make payments as a way to drive better credit outcomes. But we do want to make sure that the experience is great for consumers who are our best consumers. And our best consumers are those who do engage in the platform a lot and pay us back on time. And I think that is how we would approach the problem. Let's make sure that those users have a really rewarding and positive experience with us.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

Makes a lot of sense. The topic that's capturing it feels like our collective zeitgeist right now is AI and we have a question from an investor, Lucian Z, how is Affirm trying to leverage and adopt large language models to improve the efficiency of the company?

Michael A. Linford
Chief Financial Officer

It's a great question. And yes, it definitely has captured the imagination and focus of a lot of folks. What I would start with is machine learning and data science have been at the core of what we do from day one, and that will always be the case. But we've always stopped short of using the moniker AI to describe what we do, mostly because we think things like explainability and repeatability are really important for our platform because of the nature of the regulated space that we're in. I think it's really important that we're not building models that are difficult to understand and/or subject to things like hallucination.

And so there are certain set of problems that we do, which will always be machine learning and data science driven that will -- you'll never hear the words AI come out of our mouths, and that's certainly true for the core underwriting problem. But there's a lot more than underwriting as the question implies. There's opportunities for developer productivity, enhanced with large language models and various offerings out there that we do both use and think are really valuable. Our developers do benefit from all the trends that are out there with respect to assistant technologies in developing new software.

And then obviously, there's a lot of work that we think there's in the core customer service and user engagement, but maybe not in ways of people think quite so linearly. One of the things that Max, our CEO talks a lot about is the fact that these are great tools to assist in doing work more efficiently. And so one of the things that we would always look to do is how can large amounts of text and other recordings be consumed more efficiently by human beings. And those efficiency opportunities are very real for us and things that we're focused on.

But again, I think pretty far away from the core problem at Affirm, which is really managing strong credit outcomes. And so it's just not – not a thing I don't think you're going to see us try to waive a lot of flags on just because it's kind of core -- or away from the core problem that we solve, and it's much more a way for us to move more quickly and gain a little bit of speed and efficiency much more so than something transformational for Affirm.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

And then so maybe as it relates to the underwriting, maybe we should just step away from the moniker AI, but in the same sense, like one of the things that we've always appreciated about Affirm is just the sheer amount of data that can go into your underwriting capabilities, right? And we think that obviously differentiates itself from consumer lenders who are just making one underwriting decision based on the credit score versus your transaction level underwriting. But I think also that you guys differentiate yourself from the other BNPL providers given with the relationships you've had in the past that are very high-value transactions, those are much more difficult to underwrite than, say, $150 pair of shoes. So maybe you can talk about like what that machine learning and sophistication looks like? And do we see like an inflection curve in either the ability of your underwriting capabilities or growth potential from that compounding data accumulation.

Michael A. Linford
Chief Financial Officer

No. We talk a lot about our continuous improvement in underwriting as leaning to sprint to stay where we are. So we feel like we have an advantage. We feel like it's very real. And a lot of our work is to maintain that advantage. We don't see some sort of breakthrough or inflection on the horizon with respect to credit outcomes. If anything, that's what you saw last year as you saw this inflection around how Affirm was performing and how the rest of the market performed, more of it is a display of what happens when we choose to operate the business the way we did last year. And I think it's reflective of everything you mentioned.

So we have excellent models, and I'll talk more about those in a second, but we also have a structural advantage here in doing transaction-level underwriting. It creates better credit outcomes, which are good for all involved and it creates the ability for us to sort of risk with more opportunities to sort risk. And when you have that, combined with really good models, you're able to generate differentiated credit results. And our models are really good. You mentioned our ability to consume data. We do consume a lot of data. We're one of the larger consumers of the raw credit bureau data. We ingest all that information. We were able to retrieve data in real time and that's so important.

The underwriting problem at Affirm is to do it quickly. It's -- if you're thinking about a mortgage, consumers are well trained to expect that to take a long time, days, weeks even. I think when you're purchasing a pair of shoes as you mentioned, it is really important that we're able to make a decision in real time. And a lot of our technology advantage and data and underwriting advantage is also in how it's applied to be able to do that in real time, in a low friction way at checkout is very special. And so our data science team, machine learning experts that I think they're the best in the world, and they are tackling a very specific problem, is how do we sort risk in as near real time as possible with the signals that are available in real time. And that is the challenge for them that they're, I think, quite good at. And all of the investment that we make there is really so that we continue to have what we think is a better mousetrap that again allows us to generate really differentiated credit results, which in turn allow the capital markets to function really well for us, which in turn allows us to acquire more merchants and the whole thing really does work in concert.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

Yes, that's very interesting. One recent headline that I don't think many investors and ourselves included have fully grappled with what the implications of it could be. And I'm talking about the CFPB late fee pronouncement where they're taking it down from the $31 max down to $8, given you guys don't charge late fees in your ethos, would you see any impact from this, be it from a competitive perspective or otherwise? I start to think if these other businesses have a significant dependence on late fees, that may kind of constrict like the amount of loan growth they're willing to kind of extend and potentially you guys step in place?

Michael A. Linford
Chief Financial Officer

Yes. I think we -- when we started off -- and it took a pretty, I think, strong position on things like late fees and deferred interest and other tools that the financial institutions had relied on historically, a lot of folks, a lot of investors, partners, et cetera, I think regarded what we were doing with some level of skepticism that it could work. And I think even still, it's pretty interesting to me, if you look at a lot of the traditional financial institution response to the late fee -- proposed late fee rules, they seem to imply that they can't possibly underwrite without them. And I think that's very interesting to me. And yet, we were intentional about it and consistent about it.

The guiding principle behind the no late fees approach we have at Affirm is that we're never going to put ourselves in a position to profit off of a consumer's misfortune or mistake. So if you forget to make a payment or something happened to you, that's never an opportunity for Affirm to profit. And what that does is it keeps us aligned with the consumer, we think. And yes, it makes underwriting a really important part of our business, but that we thought was table stakes anyway. And so we can't make it more important. It's just obviously very important.

And so we felt like we were pretty bold in how we started, but we're pretty excited now that, that's clearly where this industry is headed. I think the expectation will increasingly, we believe, be set that these products should be delivered without late fees, that the challenge of underwriting should be borne by the provider and that you should not rely on the crutches in order to deliver the results that you need to deliver.

And so we look at this as saying, like, that's great, and we think we're ahead of the curve and where we welcome the level playing field that will start to get created. And I think anything more tactically is, like you said, it's a little bit hard to understand exactly how it plays out. I think that undoubtedly, some of the more traditional financial institutions will attempt to offset the lack of late revenue with other ways to extract value out of consumers. I think the more that they do the fine print, random fees, and the like, the more it accreates to us just because I think consumers are pretty fed up with that. And I think if you have a simple, transparent and honest product like ours, it looks even better, the more gunk, I think, that's thrown into the system.

And I think for merchants, in particular, the largest big boxes, I think they're going to have to confront what happens when the profitability of some of their private label credit cards is diminished. I think it's going to create competitive opportunities for us that we're pretty excited about because a lot of merchants have really profitable private label card programs that sometimes get in the way of us developing direct relationships. And I think anything that is weakening of those programs really is a benefit to us. So we think that's all great. And yet, we're mindful of the fact that -- there's no rule or regulation that ever really does happen quickly or in a way that's as linear or as overnight as people think.

And so I don't think in the near term, it changes a whole bunch about what we do, except it's a good data point to reinforce that what we've been doing, the way we've been going about it is different. And beyond that, we just think it's a net -- on the margin net benefit to level the playing field a little bit.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

Yes. Could be a fascinating development over time, though. Now that growth has stabilized post rate cycle to a certain extent, obviously, the Fed was out on Tuesday giving their forward expectations. But we do have more visibility than where we were this time last year, right? And so with that visibility, do you see -- do you gain greater confidence in your investment strategy because of that visibility? And how are you thinking about that in the year ahead?

Michael A. Linford
Chief Financial Officer

It's a good question. I think that -- we feel like we've done all the work that we're supposed to do to operate in this macro environment. And we feel really proud of that. Again, if you think about our Q2, which is usually seasonally the low point in the year per unit economics, just given the way the math works on the income statement and balance sheet. The fact that we were as strong as we were in our Q2 is a point of real pride for us. And so we feel like from a macro perspective, the business is in really good shape to navigate the current macro environment. And so when the Fed does or doesn't move, really doesn't change anything about how we make our investment decisions.

Right now, we're -- the most important thing was to be able to retool the business to operate in a higher rate environment, we've done that. And so at this point, we're not watching the Fed to get signal about how we invest. We're building the business we want to build. And I think that's, I think, a pretty positive thing for the future for us. I think there are players out there who are waiting for cuts to make investments, and we're not in that mode. We're in a mode of -- we really like the work that we've done already, and that allows us to be more aggressive and to get on to the task of scaling the network versus being reactive to the macro environment.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

That makes a lot of sense. Getting a common question from the retail community here. I think best to succinctly summarized by Adam W is when and how do you plan to reach GAAP profitability?

Michael A. Linford
Chief Financial Officer

So we have not given any outlook for GAAP profitability, either in our annual outlook nor have we communicated any date. So I can't do that now. I think the “how”, though, we can talk through. If you look at the last quarter, we had $172 million of GAAP operating loss. $134 million of that was associated with the enterprise warrants, the associated comp expense from the enterprise warrants. And as a recap, there are two big pools of enterprise warrants, some from Shopify, a deal that we did and get in 2020 and some from Amazon, we did in 2021.

The mechanics of how those things get valued in expense to the P&L is a bit arcane, but suffice it to say, those are things that happened very much in the rearview mirror. And they're really not addressable and the majority of the dilution has already been born from both of those two programs, if not almost all of it. And so -- while it is a real expense, and it definitely hits the P&L, it's also a noncash item that isn’t going to repeat and isn't even driving dilution right now. And so when you think about what's left over, that number is obviously much smaller. And I feel like the calendar does a lot of work, meaning eventually the warrants fully expense out and the scale of the business, will we think eclipse the rest of it.

And so we remain very confident that we will both generate strong GAAP profitability, but also generate strong cash flow in the business, both of which I think we're excited about into the future. For now, we've talked about running the business with strong adjusted operating margins. And I think, again, that's a number that's been a bit ahead of schedule. Over the past several quarters, you've seen us really do much better than we thought we would. And I think that's a reflection of the operating leverage in the business.

And so whether it's on an adjusted basis on a GAAP basis, the way in which we drive profitability is grow the top line of the business to grow those unit economics that revenue less transaction costs, faster than we're growing our expenses. And the truth is the way in which we went about building this business allows us to drive really strong operating leverage. We're not a company that's relying upon performance marketing to drive the short-term results. We're not a company that has massive levels of marginal cost for marginal growth. We're a company that builds software and technology products that scale really, really well. And a lot of our investment is for incremental step changes of new scale, not for continuing to run the programs that we have in place. And that's why over the past year, you've seen us drive so much leverage because we haven't had to add a lot in order to generate some real growth.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

But let's say you did want to add a lot -- to add more growth. Where would you kind of like outline the most exciting investment opportunities for you?

Michael A. Linford
Chief Financial Officer

Yes. I hate to be a broken record on this, but we think the biggest opportunity in dollars and in percentage of growth is right here in the North American market in our core business, driving further share of checkout that will show up with more distribution, i.e., new partners. It will show up with more programs, more product offerings at the merchant sites. And it will show up with other distribution with partnerships like we have with wallets. And all of those opportunities for us, we think, are very big, and those will remain the area where most of our investment sits because those are the biggest things.

I think the things that we talked about as being slightly more strategic like international, will attract some investment dollars, but we don't expect those to be material contributors in the super near term. Those are the things that we're doing for more medium-term strategic reasons. And so the biggest stuff is really the core. And I know that can be sometimes unsatisfying because there's kind of a lack of shiny balls. But I think the opportunity ahead of us is so big. The market is so large and that focus has served us so well. I think we're going to keep chipping away at the core problem as a primary focus for us.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

No, no. I think I understand the reasons for that. And I think you gave a little bit more color that if there was a step-up in investment, it would primarily be in sales and marketing and not necessarily big investments into the R&D side to kind of get the platform where it needs to be.

Michael A. Linford
Chief Financial Officer

No, I think the other way round. I think that the investments in technology and R&D would be for net new things. So I think it would be big unlocks. We build new products, that would be an area of investment. I don't think that we need investments a step change, certainly on a percentage basis in sales and marketing investments in order to enable growth, mostly because of the nature of how we go about growing.

We build products and we have an awesome go-to-market team, and they're really important to what we do. But we don't have a business model that says, $1 of ad spend results in $1.10 of revenue. It's just not -- that's not the business model that we have. We have a business model of building great products and partnering with the best merchants and platforms to get our product distributed. That's the approach that we've taken, and it served us quite well.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

A field of dreams approach if you build it, they will come. Another retail investor Abdul A asked the macro question at the time. How do you feel about today's economic environment in which American citizens have a record amount of debt and are dealing with inflationary pressures on basic living expenses? And do you think Affirm thrives in this environment?

Michael A. Linford
Chief Financial Officer

We think we thrive in any environment, but it is worth acknowledging that or pointing out or reminding people that we believe that what we do is more valuable in a high-rate environment. Everything that we do is more viable when money is more scarce or more expensive. And that's because of the core thing that we do is we help consumers find ways to pay for things that they need and want. And when rates are 0%, a 0% loan is okay. It's not as interesting to consumers. When rates are where they're at now, and people are steering down high single-digit mortgages or 30% APRs and credit cards, the ability for us to offer a cool mix of 0% paid for interest-bearing loans to consumers is truly viable to them in a way that really is, I think, highly differentiated, highly visible to them in the current rate environment.

I think the inflation-driven trends for consumers have been things that really will just continue to put pressure on households. I think a large part of that has played out already. We feel like most of the pressure on consumers is already embedded in kind of the current macro environment. It doesn't mean it's going to get better, right? The stress is very much there, but we feel like it's been very consistent. And if you think about one word that I think is pretty fair to describe the past 18 months or so, it’s volatility. It’s that things have changed a lot. And I think that whenever you have a dynamic situation, whenever you have a lot of volatility, the players that do best are the ones who have the most tools, the most flexibility, the most agility and Affirm’s transaction level underwriting, our technology focus and our unique distribution has really allowed us to navigate this market better than anyone. And I think that is I think that’s one of the real reasons we feel so confident about this environment or really any environment is we’ve got the tools to navigate here.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

And that’s an interesting way to put it, where the consumer has the consciousness of rate dynamics, but then you guys can step in and present those dynamic offerings is a really interesting way to frame it. We’re coming up to the top of the hour here, but I wanted to squeeze in a broad retail investor question to help kind of book end the conversation. I mean what are the main challenges of Affirm this year? This is from Tamesta L. And maybe if I could follow on to that. Fast forward one year from now, and we’re having this conversation again, what would you kind of envision as a baseline level of success in the eyes of Michael Linford.

Michael A. Linford
Chief Financial Officer

I think we really do measure ourselves in years and even decades, and so we have a very long-term perspective on where we’re headed. And so I think the next 12 months are really about executing the stuff that’s already right on our plate. And we have a lot to do in the next 12 months, and we’re going to stay focused on that. And stay focused on delighting as many consumers as possible, driving as high of conversion as we can for merchants and delivering, we think, really differentiated performance on the asset side, so really strong execution in the capital markets.

And I think the challenge for us right now is to take advantage of some of the hard work and I think even lead that we've built in a lot of areas. It's -- it was a situation last year where we had to be reactive to a lot of what was going on in the world. The dynamic environment with rates, you saw banks failing. You saw a lot of really difficult and sometimes really volatile things happening in the world. I think this year, we feel like we've gotten through all of that. And so the challenges are pretty exciting for us because they really relate to going back to the core thing of scaling our network. And I think it's really interesting from my perspective anyway, the way in which this company has gone from really being completely unaware -- a lot of consumers were even unaware who we were, to as the category has grown, we became more aware to both merchants and consumers. I think we've got in the period of 2021, there's a lot of excitement for what it can be.

And I think the volatility of the past year caused a lot of people to think about, what is the actual role of a business like ours in the future of commerce. And I think where we are now puts us back into where we were a few years ago with a real chance to demonstrate the inevitability of the category of the future of these kind of alternative ways to access credit and the value that we can drive to consumers when we do it. So the challenge for the next year is to really take advantage of this opportunity that we have given all the hard work and investment we made over the past 1.5 years to take advantage of it right now in the current market.

Andrew Thomas Bauch
Wells Fargo Securities, LLC, Research Division

Yes. That's great. Well, Michael, we will give you three minutes of your Friday back. We want to thank you so much for allowing us to host this fireside chat. And we will be looking forward to documenting that growth that you continue to speak about in every step of the way. So for that, have a great weekend, Michael.

Michael A. Linford
Chief Financial Officer
Thank you, Andrew. And thanks, everybody, for listening. Thanks.