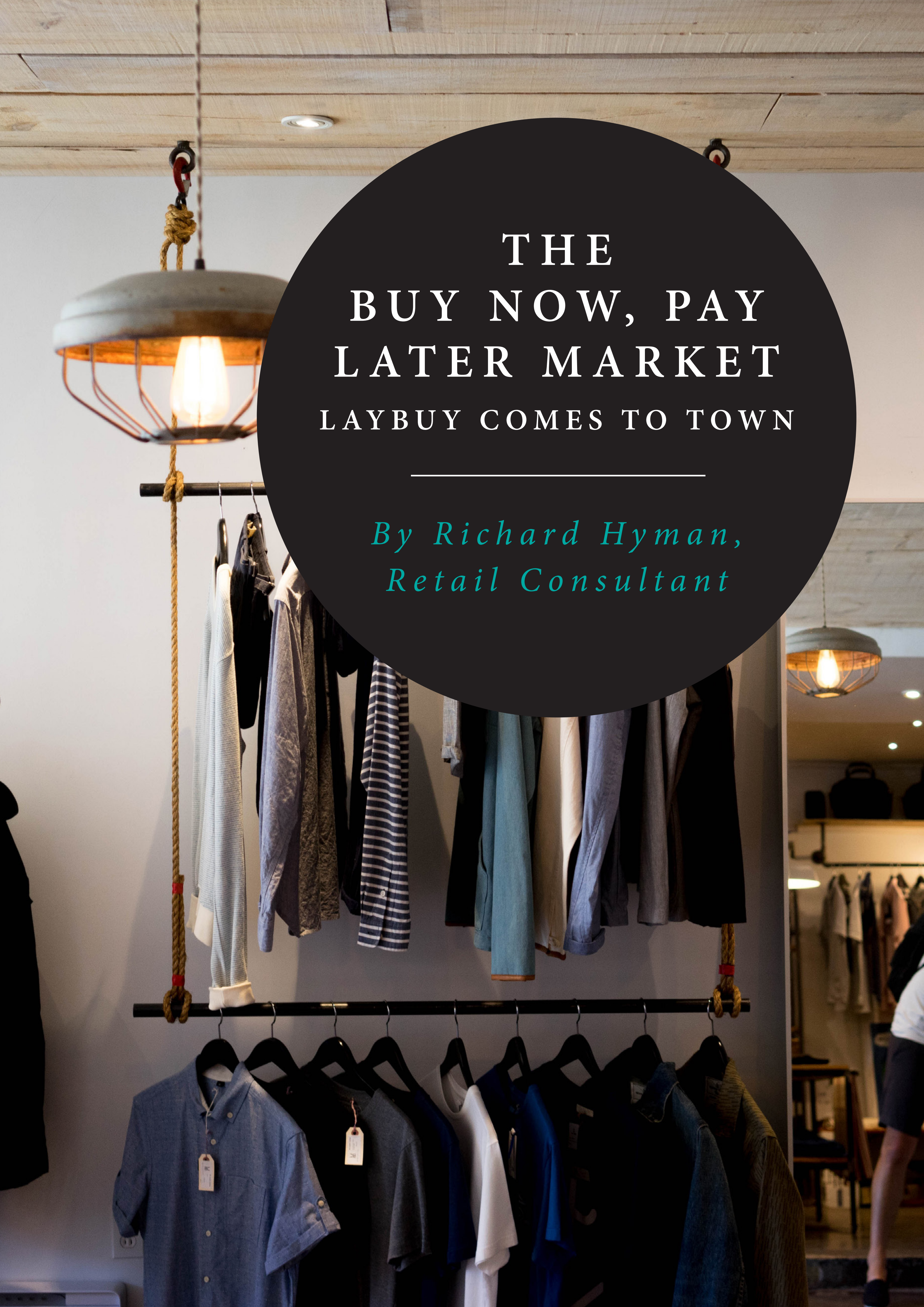

THE BUY NOW, PAY LATER MARKET

LAYBUY COMES TO TOWN

By Richard Hyman, Retail Consultant

New payment systems are emerging in the UK retail market. ***Issues with payments are a key driver of the incredible 60% shopping basket/cart abandonment rate quoted widely across ecommerce.*** *These include the need to create online accounts, problems with payment security and simply the length and complexity of the checkout process.* ***These new services address around half the abandonment issues. This alone would make them significant. But there is potentially much more.***

In a market dominated by debit and credit cards, new services are giving these established payment methods a run for their money. They promise to deliver real benefits to both retailers and consumers.

CONTENTS

THE BUY NOW, PAY LATER MARKET

LAYBUY COMES TO TOWN

ABOUT THE AUTHOR
04

UK RETAIL BACKGROUND
05

CONSUMERS
06

CARDS
07

LAYBUY
09

COMPETITION
12

UK EXPANSION & OUTLOOK
13

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Richard has worked with most of the leading retailers in the UK over the past 30+ years. Over this time, he has built up an unrivalled insight into every sector of the retail market, the leading companies in each and the management teams that lead them. Richardtalksretail provides access to this insight and opinion.

Richard started his career as a researcher at the Financial Times in the 1970s. He went on to work first as an analyst then a Director of Mintel. In September 1984 he left to launch his own business, Verdict, formed to focus on delivering a new breed of insight and analysis of the retail sector. He sold Verdict to Datamonitor in 2005 and went on to be Strategic Advisor to Deloitte.

Over this period Richard has provided strategic advice to most of the leading retailers in the UK, their product suppliers, landlords, bankers and institutional shareholders.

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UK RETAIL BACKGROUND

For retailers, growing sales and managing cash flow have become more critical than ever before. Making it as easy as possible for customers to shop is vital.

Both sides of the retail supply/demand equation are suffering. After generations of relentless growth in physical space, the internet has come along and added loads more capacity, albeit in digital form. Very little online capacity has expanded the spending cake. It has mostly cannibalised, sucking business out of stores and on to websites.

Led by Amazon, online retail has added costs through investment in tech and fulfilment of orders. And as Amazon in particular keeps raising the customer service bar, so most of its rivals play catch up and follow. Meanwhile the costs of running shops have continued to rise, from rents and rates to heating, lighting and of course, staff.

Meanwhile, consumers have faced increasing pressure on household budgets. Average UK earnings today are struggling to match those of 10 years ago, pre-debt crisis. General living costs have continued to rise and a consumer spending squeeze has become inevitable.

Retailers have never felt so much pressure, with too many stores and too many websites. Faced with increasingly disloyal customers and rising costs, squeezed margins are inevitable. Retail management response has been varied but increasingly involves a diet of increased promotional activity and cost cutting, usually through culling staff.

This is the background to the biggest structural change UK retailing has ever seen. With online penetration of UK non-food retailing now at c25%, trading economics are severely impacted. We are seeing increasing distress with a growing number companies seeking the protection of CVAs and administrations while for some, it is too late and they face the exit door.

For retailers, growing sales and managing cash flow have become more critical than ever before. Making it as easy as possible for customers to shop is vital. However, so too is the need for the tight management of bad debt through sophisticated risk assessment and credit checks.

CONSUMERS

Research by Censuswide for Laybuy shows that almost 70% of consumers actively manage their finances from week to week. This is especially true of millennials.

A common thread across almost every aspect of our lives is speed. Tech has allowed us immediate access to information, communication and encouraged us all to demand immediacy in everything. Retail is no exception – consumers want instant gratification.

Millennials are a critical consumer group and the most pressured financially by the wider economic squeeze. Many are having to live at home for longer and more generally, rely far more on parents for financial support. So while much in their lives is becoming rapidly more sophisticated, they are much less independent than they would like. This impacts their credit scores – lower home ownership, lower ownership of cars and household durables and constrained spending means thin histories. And their spending patterns are affected.

Pressure on wages and spending means that pay day remains a critical spike in the retail trading cycle. In fact 13% (or 4.2 million) of wage earners still get paid weekly. Research by Censuswide for Laybuy shows that almost 70% of consumer actively manage their finances from week to week. This is especially true of millennials. Having an option that allows consumers to buy now and buy later, at no cost to themselves, is obviously very attractive.

CARDS

Over the years, credit cards have attracted a good deal of adverse publicity through high APRs. After years at rock bottom levels, interest rates are starting to edge up. The opportunity to enjoy what is in effect short term interest free credit is bound to be attractive.

Cards dominate purchasing in the UK consumer economy. Estimates based on data from the UK Cards Association show that around £320bn of retail spend will go on cards this year. Retail here has a wide definition and this figure includes fuel at £35bn and food & drink at £122bn, leaving total card spend on non-foods of £163bn.

I'm forecasting total UK non-food retail sales will be worth £215bn by the close of 2018. This means card transactions account for 76% of all spend, a figure which underlines the scale and deep penetration of this payment method in the UK.

Within the overall cards market, credit cards account for 30% of spend with debit cards claiming the balance. In spite of already very high penetration rates, both types of card continue to grow. Credit cards more modestly at c2% but debit cards faster at 4.0%. Online is interesting. Here, cards have a slightly lower share at 72%, reflecting the continued importance of store credit cards in the market. A key point concerns growth rates. Online retail sales are increasing at +15% pa whereas physical retail is largely stagnant. So while penetration may be lower, card spending will still grow faster online than offline.

Over the years, credit cards have attracted a good deal of adverse publicity through high APRs. After years at rock bottom levels, interest rates are starting to edge up. The opportunity to enjoy what is in effect short term interest free credit is bound to be attractive.

Probably the biggest attraction for retailers is Laybuy's ability to generate incremental sales.

Laybuy was born in New Zealand in May 2017. It is a payment system that allows customers to buy now, pay c.15% of the selling price upfront, and the balance over the following 6 weeks. Use is free with no interest to pay. Sign up and credit check is instant, via smartphones. For retailers, the credit risk is 100% born by Laybuy. Sale proceeds minus a fee (typically 3% - 4%) are guaranteed to be remitted within 48 hours of purchase. Integrating Laybuy into existing systems appears to be simple, quick and low cost.

With only c8% of New Zealand retail sales online, it is not surprising that Laybuy started life as a service dedicated to online and physical retailers. This is an important point of difference with Afterpay and Klarna who are both much more heavily biased to online.

The business has grown very fast in New Zealand and is doing the same in Australia. It is due to arrive in the UK soon and is already signing up retailers here.

Unlike Australasia and the US (where the idea was born), the "layaway" concept has never taken off here. This is where customers make a purchase, make a down payment but only take possession of the purchase once they have fully paid for it. Here we have focused more on HP (hire purchase) and credit through cards, plus what used to be called agency mail order back when it was dominated by catalogues.

While Laybuy's inception was influenced by layaway and the opportunity to find a better way, there are more than enough benefits for both customers and retailers to make it a very viable payment system in the UK.

The economic squeeze on both household budgets and retail cash flows are a good starting point. The cost of money on credit exceeds both the rates of sales and wage growth. UK data show that payment methods here are dominated by debit cards, meaning you avoid credit charges but are paying 100% upfront – fine for many but challenging for some, particularly young adults.

For retailers, managing cash flow has become the number one priority. This has become the toughest retail market we have ever seen. Corporate distress (credit insurance pressures, profit warnings, staff layoffs, administrations and CVAs are all symptoms of painful structural change across the industry. The instant remittance of sales and low running costs of Laybuy will be particularly relevant.

OFFERING SOMETHING COMPLETLY NEW

	Automatic weekly payments	No minimum spend	Boost your purchase	Omni channel solution	Instant credit checking & approval	Start accruing interest if late
LAYBUY	✓	✓	✓	✓	✓	✗
Klarna.	✗	✓	✗	✗	✓	✓
Klarna.	✗	✓	✗	✗	✓	✓
PayPal CREDIT	✗	✗	✗	✗	✗	✓

Probably the biggest attraction for retailers is Laybuy's ability to generate incremental sales. The numbers from New Zealand and Australia are impressive. Up to 40% of signed up retailers' traffic (in store and online) are choosing to pay via Laybuy. Basket sizes are up by up to 60%. Significant hikes in frequency of visit and conversion rates have been recorded while customer acquisition rates of over 30% all add up to a very impressive CV.

Laybuy's impact on returns in the New Zealand retail market has seen significant reductions. Return rates in the apparel market there are c25% and merchants have reported a fall to low single digits. Our returns are c40% and clearly, shoppers in our much bigger online market have become used to ordering lots of items (size/colour variants) and sending many back. Even a modest reduction in returns would have a very positive impact on profitability.

OFFERING SOMETHING COMPLETLY NEW

	Merchant paid within 3 days	Low returns % with payment type	Easy intergration	Omni channel solution	Incremental referral traffic
LAYBUY	✓	✓	✓	✓	✓
Klarna.	✓	✗	✗	✗	✗
Klarna.	✓	✗	✗	✗	✗
PayPal CREDIT	✓	✓	✓	✗	✗

Allowing alcohol has attracted some adverse PR and Afterpay has been forced to tighten some checking procedures as a result.

There has been lots of activity in the space in recent years. The launch of Klarna is the most eye catching because it was the earliest but also reflecting its scale. These buy now pay later models have attracted some adverse publicity, the suggestion being they make it easy for people to spend more than they should through deferred payments. Unlike Laybuy, neither Klarna or Afterpay require customers to make any upfront payment at all. Laybuy believes the c.15% downpayment central to its model is a point of difference and represents a significant commitment from consumers.

Klarna is Swedish and describes itself as a bank. It started out in 2005 when its three founders developed a new innovative payment service. The company provides consumers with pay now, pay after delivery and credit-oriented options. Klarna accounts for around 40% of all online business in its home country. It launched in the UK in late 2014 and expanded into the US in 2015. The company currently boasts 60 million customers worldwide through 90,000 online stores, handling c$21 billion of sales and c800.000 daily transactions.

The idea of paying later is embodied in its branding – the on-screen 'Pay Later' purchasing option allows consumers to have products delivered now and pay within 14 or 30 days of the shipping (plus a 10 day grace period). The potential to "own now and not pay for 30 days" is heavily marketed. Approvals are not based on payment information but rather through a real-time risk assessment algorithm based on purchase history and contact information. They market "soft credit checks which do not impact your credit score" to potential customers.

Klarna charges retailers an average 3.2% merchant fee. Among UK retailers signed up are JD Sports, Swoon (the furnishings store), Top Shop, Asos, The Fragrance Shop, Burton and Dorothy Perkins. It was interesting that when it signed up Asos last November, its PR campaign positioned the service as "try before you buy", echoing the Amazon Prime Wardrobe service and seemingly encouraging high returns. Klarna's online directory lists 110 retailers including Asos and al, the Arcadia brands.

Afterpay is an Australian business founded in 2014 and it too has launched into the US market in May 2018. In August 2018 Afterpay acquired UK based ClearPay. In ClearPay's model, customers are able to purchase items up to £450 in value and repay in three interest free monthly instalments. The acquisition is intended to accelerate and de-risk Afterpay's entry into the UK. Its plan is to phase out the ClearPay model in favour of its own. ClearPay currently lists 36 "featured retailers" on its website.

Afterpay has a very similar model to Klarna. It provides consumers with a short-term, deferred payments service, allowing them to "buy now and pay later". There is no interest, hidden fees or loan application forms. The purchase value is recouped from consumers typically in four equal, fortnightly instalments. Afterpay assumes all non-payment risk in exchange for a merchant fee, leveraging their platform to assess repayment capabilities and fraudulent activity in real time. Merchant charges are believed to be c4%.

While Klarna and Laybuy both use external independent credit checking services, Afterpay uses its own algorithm and appears to have a more relaxed attitude to extending credit. It also covers a much wider spectrum of consumer spending including alcohol. Allowing alcohol has attracted some adverse PR and Afterpay has been forced to tighten some checking procedures as a result. Laybuy and Klarna focus on a narrower market, closer to the traditional definitions of retail.

The service is targeted at online retail merchants and is rolling out in-store versions to replace the generally unprofitable lay-by payment method.

UK EXPANSION & OUTLOOK

Laybuy has worked closely with retailers, partnering with them to reach out to customers. The retailers have embraced these digital platforms and marketed Laybuy to their audience.

Looking at the various brands among this still new'ish group of payment services, speed of adoption by both consumers and retailers is a key characteristic. And beyond this is just how easily transferable the business models have been internationally.

The longest established of these companies, Klarna, quickly adopted the Swedish business tradition of quickly looking beyond its borders for growth. It has rapidly replicated its development model across Europe and more recently, the USA.

Afterpay quickly spread its wings beyond Australia and is now very focused on rapid growth in the USA.

LayBuy is the newest of the three and has a slightly different model as discussed earlier. It rapidly exported its service from New Zealand to Australia and is now launching in the UK. Laybuy has worked closely with retailers, partnering with them to reach out to customers. The retailers have embraced these digital platforms and marketed Laybuy to their audience.

The early adopters of these payment services are millennials and reaching them through intensive use of social media has already proved to be the critical route to rapid growth.

Growth at both Klarna (Europe and USA) and Afterpay (Australia and USA) confirms the social media route works in exactly the same way. The role of social media here in the UK and its relationship with consumer behaviour and spending is virtually identical.

I have already discussed retail spending and the pressures faced by consumers and retailers alike. From the demand side of the equation the portents are good. Consumers are very likely to embrace a simple, transparent payment methodology that is free of charge, helps them manage their cash flow and gives them instant gratification.

Retailers are desperate to increase their sales. The data from LayBuy on incremental sales through much improved conversion rates is impressive. Merchant costs appear very reasonable and retailers bear no responsibility for any debt. All the evidence from more mature companies further down the development road is encouraging. LayBuy and similar services will certainly become a large and permanent part of modern shopping here in the UK.

THANK YOU