

Analyst

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Afterpay Touch Group (APT)

Growing Confidence

Recommendation

Buy (unchanged)

Price

\$18.15

Target (12 months)

\$28.02 (previously \$25.04)

GICS Sector

Software and Services

Expected Return

Capital growth	54.4%
Dividend yield	0.0%
Total expected return	54.4%

Company Data & Ratios

Enterprise value	\$4.2bn
Market cap	\$4.3bn
Issued capital	236.7m
Free float	80%
Avg. daily val. (52wk)	\$25.8m
12 month price range	\$5.26-\$23.00

Price Performance

	(1m)	(3m)	(12m)
Price (A\$)	15.24	10.63	7.39
Absolute (%)	19.09	70.74	145.60
Rel market (%)	14.17	62.19	142.69

Absolute Price



SOURCE: IRESS

The model appears to be working

APT has delivered one of its most important result. It has shown that it can expand overseas while maintaining a lid on bad debts, and a stable overall net-margin. It was able to absorb late fee caps, and invest heavily into establishing the U.S. business. The model looks like it is working, in Australia Afterpay EBITDA jumped from ~\$17m in 1H18 to ~\$35.7m in 1H19. This improvement was hidden by investment in the international expansion.

The three variables we are most interested in

The risk to our valuation is primarily driven by the following three factors:

- 1 Customer Growth Rate;
- 2 Net-Margin Trajectory; and
- 3 Attrition Rate of Customers.

All three of the above factors are tracking ahead or in line with expectations. We consider APT's decision to invest heavily for growth (\$20m flagged in FY19 and topped up at this result by a further \$10m), as a good strategy despite the short-term impact on earnings. The value of the business, we argue, will follow the customer growth as long as the net-margin and attrition rates remain relatively stable.

Earnings revisions

Following APT's 1H19 result, we have upgraded our underlying active customer estimates by between 2.6% - 21.8% over the forward estimates, while we have downgraded our FY19 underlying EPS from positive 3.7cps to -4.0cps (primarily driven by an additional \$10m investment to accelerate growth), and downgraded FY20 EPS by -12.1% (similar reason). There is an increase in our FY21 underlying EPS of 5.2% as the customer growth kicks in. We note that our CLV valuation methodology prioritises customer growth, particularly where gross margin and retention rates are healthy. Following these changes our revised Price Target is \$28.02 per share (previously \$25.04), with our Buy recommendation remaining unchanged.

Earnings Forecast

Year end June 30	2018	2019e	2020e	2021e
Sales revenue (\$m)	113.9	210.7	396.9	641.9
EBTDA (Adjusted) (A\$m)	27.7	14.0	55.7	114.1
NPAT (reported) (A\$m)	-9.0	-43.7	10.0	48.5
NPAT (adjusted) (A\$m)	8.9	-9.8	30.0	68.5
EPS (adjusted and fully diluted) (cps)	4.0	-4.0	11.9	27.2
EPS growth (%)	Large	Large	Large	128.5%
Adjusted PER (x)	456.2	-459.1	152.4	66.7
Price/CF (x)	-33.4	-34.0	202.1	73.7
EV/EBITDA (x)	160.2	317.2	79.5	38.8
Dividend (eps)	0	0	0	0
Franking (%)	na	na	na	na
Yield (%)	0.0%	0.0%	0.0%	0.0%
ROE (%)	5%	-4%	9%	19%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Highlights and Assumptions

1H19 result highlights

- EBTDA of \$12.1m (pre accounting change and one-offs) vs our \$17.6m estimate;
- Customer numbers at 3.5m as at 22 Feb, up from 3.1m at end of December;
- US forecast to have 1.0m customers by end of March;
- Net-margin stable at 2.3%;
- Net transaction loss at bottom of target range 0.6% (vs 0.6% - 1.0% guidance);
- APT to invest a further \$10m in US and International expansion in 2H19; and
- UK set to launch in 2H19, with Urban Outfitters confirmed as initial client.

Key Assumptions

Following APT's changed reporting, its move to half yearly updates (as opposed to quarterly), and due to the international expansion, we have rebuilt parts of our financial model and some of the revised key drivers are noted below.

Figure 1 - Key Assumptions Afterpay

Active Customers (m)	1H19	2H19e	1H20e	2H20e	1H21e	2H21e
ANZ	2.5	2.8	3.1	3.4	3.7	4.0
US	0.7	1.6	2.7	3.9	5.1	6.3
UK	0.0	0.1	0.3	0.6	1.0	1.4
Total	3.2	4.5	6.1	7.9	9.8	11.7
Margin (%)	1H19	2H19e	1H20e	2H20e	1H21e	2H21e
Merchant Fee	3.7%	3.7%	3.7%	3.7%	3.7%	3.7%
NTL	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%
Processing and Financing	-1.1%	-1.1%	-1.2%	-1.2%	-1.2%	-1.2%
Net-margin	2.1%	2.1%	2.0%	2.0%	2.0%	2.0%
Transaction Value (\$m)	1H19	2H19e	1H20e	2H20e	1H21e	2H21e
Total	2,273	2,868	4,713	5,371	8,105	8,496

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Valuation and Changes

Valuation

We utilise a Sum-of-the-Parts Valuation, with the key Afterpay component relying on a Customer Lifetime Value (CLV) based methodology. The key assumptions in our valuation can be found in the table below. Our total APT valuation is \$28.02 per share (previously \$25.04), which forms the basis of our Price Target, and is supportive of our Buy recommendation on the stock.

Figure 2 - Valuation

Sum-of-Parts Valuation

Afterpay Customer Lifetime Value based methodology	
Discount rate (%)	10.1%
Retention rate estimate (%)	85%
Weighted three year customer numbers*	5,205,000
Customer annual spend (\$0.00)	1,476
Gross margin (%)	1.91%
NPV of customer gross margin (\$0.00)	<u>\$411.23</u>
Afterpay CLV based valuation (\$m)	7,240
Net-cash (\$m)	-18
Pay Now valuation	129
Corporate	-294
Total APT value (\$m)	7,058
Fully diluted share count (m)	252
Valuation per share (\$0.00)	28.02

* (50% weighting to Financial Year 0, 35% to FY1e, and 15% to FY2e)

SOURCE: BELL POTTER SECURITIES ESTIMATES

Customer numbers and earnings revisions

Following APT's 1H19 result, we have upgraded our underlying active customer estimates by between 2.6% - 21.8% over the forward estimates, while we have downgraded our FY19 underlying EPS from positive 3.7cps to -4.0cps (primarily driven by an additional \$10m investment to accelerate growth), and downgraded FY20 EPS by -12.1% (similar reason). There is a slight increase in our FY21 underlying EPS of 5.2% as the customer growth kicks in.

Figure 3 - Earnings revisions

Earnings Revisions	FY19e (new)	FY19e (previous)	Change (%)	FY20e (new)	FY20e (previous)	Change (%)	FY21e (new)	FY21e (previous)	Change (%)
Customer numbers	4,500,000	4,385,000	2.6%	7,900,000	7,025,000	12.5%	11,700,000	9,605,000	21.8%
EPS (Cash) (cps)	-4.0	3.7	Large	11.9	13.5	-12.1%	27.2	25.9	5.2%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Interim earnings

Figure 4 - Interim earnings

INTERIM INCOME STATEMENT													
Y/e June 30 (\$m)	2017 ^a	1H18	2H18	2018	1H19	2H19e	2019e	1H20e	2H20e	2020e	1H21e	2H21e	2021e
Total operating revenue	22.9	49.9	63.9	113.9	94.1	116.7	210.7	186.0	211.0	396.9	313.5	328.4	641.9
Net-transaction loss	-3.1	-6.7	-2.5	-9.2	-13.6	-17.1	-30.7	-28.2	-32.1	-60.3	-48.5	-50.8	-99.3
Total other variable transaction costs	5.5	2.0	4.2	6.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Operating expenses	8.6	16.0	26.7	42.7	43.0	58.6	101.6	74.1	78.0	152.1	109.3	112.3	221.6
Adjusted EBTDA	3.9	12.3	15.3	27.7	8.5	5.4	14.0	23.3	32.4	55.7	54.7	59.4	114.1
Depreciation	0.0	0.0	1.8	1.8	0.9	0.9	1.7	0.9	0.9	1.7	0.9	0.9	1.7
Amortisation	2.7	4.8	10.7	15.5	10.3	11.0	21.3	12.0	12.0	24.0	13.0	13.0	26.0
EBT	1.2	7.5	2.8	10.3	-2.6	-6.4	-9.1	10.4	19.6	30.0	40.8	45.5	86.3
Operating income tax expense	0.3	1.5	-0.1	1.4	0.7	0.0	0.7	0.0	0.0	0.0	5.5	12.3	17.8
Underlying NPAT	0.9	6.1	2.9	8.9	-3.3	-6.4	-9.8	10.4	19.6	30.0	35.3	33.2	68.5
Share based payments	1.8	5.3	11.1	16.4	18.1	15.0	33.1	10.0	10.0	20.0	10.0	10.0	20.0
Significant items (pre-tax)	-15.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Significant tax	4.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Significant items (after tax)	-10.6	-1.3	0.3	-1.0	-0.8	0.0	-0.8	0.0	0.0	0.0	0.0	0.0	0.0
R&D grant	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reported profit (A\$m)	-9.6	-0.5	-8.5	-9.0	-22.2	-21.4	-43.7	0.4	9.6	10.0	25.3	23.2	48.5
Loan receivables													
Y/e June 30 (\$m)	2017e	1H18	2H18	2018	1H19	2H19e	2019e	1H20e	2H20e	2020e	1H21e	2H21e	2021e
Gross loan receivables	103.7	199.0	274.5	274.5	380.5	501.9	501.9	836.5	966.9	966.9	1499.5	1614.3	1614.3
Closing provisions for bad debts	5.3	13.6	15.0	15.0	28.2	28.7	28.7	47.1	53.7	53.7	81.1	85.0	85.0
Net customer loan receivables	98.4	185.3	259.5	259.5	352.4	473.3	473.3	789.4	913.1	913.1	1418.4	1529.4	1529.4
Afterpay estimates													
Y/e June 30 (\$m)	2017e	1H18	2H18	2018	1H19	2H19e	2019e	1H20e	2H20e	2020e	1H21e	2H21e	2021e
Merchant fee revenue (\$m)		37.1	51.2	88.3	85.2	107.5	192.7	176.6	201.3	377.9	303.8	318.4	622.2
Processing and Financing cost (\$m)		6.9	10.8	17.6	24.8	31.3	56.2	56.2	64.1	120.3	96.7	101.4	198.1
Gross Profit (\$m)		30.2	40.5	70.7	60.3	76.2	136.5	120.4	137.2	257.6	207.1	217.1	424.2
EBTDA		14.9	19.9	34.9	22.3	23.2	45.5	45.2	55.7	100.9	88.2	94.6	182.8
Buy Now estimates													
Y/e June 30 (\$m)	2017e	1H18	2H18	2018	1H19	2H19e	2019e	1H20e	2H20e	2020e	1H21e	2H21e	2021e
Revenue		12.9	12.7	25.6	8.9	9.2	18.1	9.4	9.6	19.0	9.7	9.9	19.6
Cost of sales		6.2	4.4	10.6	4.1	4.2	8.3	4.2	4.3	8.5	4.4	4.4	8.8
Net-revenue		6.7	8.3	15.0	4.8	5.0	9.8	5.1	5.3	10.4	5.4	5.5	10.9
EBTDA, Adj		4.6	2.7	7.2	2.5	2.7	5.2	2.8	2.9	5.7	3.0	3.0	6.0
Corporate Estimates													
Y/e June 30 (\$m)	2017e	1H18	2H18	2018	1H19	2H19e	2019e	1H20e	2H20e	2020e	1H21e	2H21e	2021e
Total underlying corporate expenses (\$m)		7.2	7.3	14.5	16.3	20.4	36.7	24.7	26.2	50.9	36.5	38.2	74.7

^aNote: Figures prior to/including 2017 are reflective of Afterpay only. 2018 onwards reflects the combined Afterpay Touch Group

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Company description

Afterpay Touch Group (APT) is an emerging financial technology company that enables retail merchants to offer customers the ability to buy goods and services on a simple instalment plan with an easy and non-invasive application process, and at no additional cost to the end-customer. It is the combined entity of Afterpay (AFY), which was founded in February 2014 by Anthony Eisen and Nicholas Molnar. And Touchcorp (TCH) the company that developed the payment technology.

Risks to investment thesis

Key risks for the stock include although are not limited to:

- **Merger/Integration risk** - Following the completion of the AFY/TCH merger, the combined group may fail to achieve the anticipated benefits, or may incur unforeseen costs in connection with the integration of both businesses which may have a material impact on the group's earnings;
- **Credit risk** – APT extends credit to end-customers via its receivables book for which the merchants pay a fee. While this is not a traditional lending model, the company is still exposed to the risk of default or a loss of principle. Therefore, the ability of APT's technology to adequately prevent and recover bad debt is crucial to the company's ongoing viability;
- **Funding risk** – APT currently funds its loan book through a combination of equity and debt, having now secured a debt financing agreement. APT's growth may be limited if it is unable to expand its receivables book through securing further increases in debt financing facilities or raise additional equity;
- **Key person risk** – Similar to other small capitalised stocks, the loss of any key personnel may be detrimental to APT;
- **Competition risk** – APT has first mover advantage offering reverse lay-by within Australia, however there is significant risk of new entrants and increased competition, particularly from established foreign companies;
- **Technology risk** – APTs algorithms assess an end-clients repayment capabilities and the risk of fraud automatically and in real-time. APT relies on its technology to process transactions and store client data. Any failure or breach of the technology could result in an interruption of service, or the loss/theft of private data and information;
- **Regulation & licensing risk** – While APT does not currently require an Australian Credit Licence (ACL), it is still subject to a range of legal and regulatory requirements. Any changes to regulations, policies, or laws could adversely impact the efficacy of AFY's business model;
- **Fraud risk** – APT guarantees payment to merchants and is therefore exposed to the risk of fraudulent end-customers. Failures in APT's algorithms to prevent fraud would adversely affect APT's performance;
- **Market risk** – A prolonged recession, economic crisis/shock, or other factors that may lead to a sustained weak market environment have the ability to increase the levels of defaults and adversely affect the earnings potential of the company. In addition, being a listed stock, the share price may be subject to volatility and fluctuations in price; and
- **Operational risk** – The operation APT relies on internal policies and technologies in relation to lending practices and anti-fraud. Any failure in internal controls could be harmful to AFY's performance.

Afterpay Touch Group

as at 26 February 2019

Recommendation

Buy

Price

\$18.15

Target (12 months)

\$28.02

Table 1 - Financial summary

Afterpay Touch Group (APT)						Price Target (A\$)	28.02	Share Price (A\$)	18.15		
						Recommendation:	Buy	Market Cap (A\$m)	4,125.5		
INCOME STATEMENT						VALUATION DATA					
Ye June 30 (\$m)	2017*	2018	2019e	2020e	2021e	Ye June 30 (\$m)	2017*	2018	2019e	2020e	2021e
Total operating revenue	22.9	113.9	210.7	396.9	641.9	Adjusted NPAT (\$m)	0.9	8.9	-9.8	30.0	68.5
Cost of sales	0.0	28.2	64.5	128.8	206.8	Adjusted EPS (fully diluted) (c)	0.5	4.0	-4.0	11.9	27.2
Gross profit	0.0	85.7	146.3	268.1	435.0	EPS growth (%)	na	large	large	large	128%
Net-transaction loss	-3.1	-9.2	-30.7	-60.3	-99.3	Diluted adjusted P/E ratio (x)	na	456.2	-459.1	152.4	66.7
Other variables	5.5	6.1	0.0	0.0	0.0	CFPS (c)	-29.2	-54.3	-53.3	9.0	24.6
Operating expenses	8.6	42.7	101.6	152.1	221.6	Price/CF (x)	-62.1	-33.4	-34.0	202.1	73.7
Adjusted EBITDA	3.9	27.7	14.0	55.7	114.1	DPS (c)	na	0.0	0.0	0.0	0.0
Depreciation	0.0	1.8	1.7	1.7	1.7	Yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%
Amortisation	2.7	15.5	21.3	24.0	26.0	Franking (%)	na	na	na	na	na
EBT	1.2	10.3	-9.1	30.0	86.3	EV/EBITDA (x)	1122.9	160.2	317.2	79.5	38.8
Operating income tax expense/(benefit)	0.3	1.4	0.7	0.0	17.8	Price/book (x)	21.9	22.2	14.1	13.9	12.1
Underlying NPAT	0.9	8.9	-9.8	30.0	68.5	NTA/share (\$)	0.83	0.82	1.29	1.31	1.50
Share based payments	1.8	16.4	33.1	20.0	20.0	PROFITABILITY RATIOS					
Significant items (pre-tax)	-15.2	0.0	0.0	0.0	0.0	Ye June 30 (\$m)	2017*	2018	2019e	2020e	2021e
Significant tax	4.6	0.0	0.0	0.0	0.0	EBIT/sales (%)	5.4%	9.1%	-4.3%	7.6%	13.5%
Significant items (after tax)	-10.6	-1.0	-0.8	0.0	0.0	Return on assets (%)	0.7%	2.8%	-1.8%	3.1%	4.4%
Reported profit (A\$m)	-9.6	-9.0	-43.7	10.0	48.5	Return on equity (%)	1.0%	5.2%	-3.9%	9.2%	19.4%
CASHFLOW						Dividend cover (x)	na	na	na	na	na
Ye June 30 (\$m)	2017*	2018	2019e	2020e	2021e	Effective tax rate (%)	30.0%	13.5%	8.0%	0.0%	20.6%
EBITDA	3.9	27.7	14.0	55.7	114.1	LIQUIDITY AND LEVERAGE RATIOS					
Change in provisions	1.3	4.4	0.1	2.7	4.8	Ye June 30 (\$m)	2017	2018	2019e	2020e	2021e
Working capital changes	-54.6	-121.7	-111.7	-37.1	-40.8	Net debt/(cash) (\$m)	17.1	136.1	304.4	794.7	1,429.7
Interest earned	0.1	0.0	0.3	0.0	0.0	Net debt/(cash) (ex SPV)*	-29.6	-25.5	-49.2	-23.8	-36.3
Tax paid	-0.8	0.1	0.0	0.0	-17.8	Net debt/equity (%)	10.7%	74.1%	95.3%	241.3%	378.3%
Associated company dividends	0.0	0.0	0.0	0.0	0.0	Current ratio (x)	117.2	259.0	565.6	1,040.6	1,737.9
Other operating items	-1.6	-23.5	-26.5	0.0	0.0	Underlying EBITDA^					
Operating cash flow	-51.6	-113.1	-123.8	21.3	60.2	Afterpay EBITDA		34.9	45.5	100.9	182.8
Stay in business capex	-0.1	-2.5	-2.6	-1.7	-1.7	Buy Now EBITDA		7.2	5.2	5.7	6.0
Growth capex & acquisitions	-17.6	-15.8	-21.8	-27.0	-30.0	W/A shares on issue	176.5	208.2	232.1	236.9	244.6
Disposals	-3.0	-5.1	0.0	0.0	0.0	BALANCE SHEET					
Investing cashflow	-20.6	-23.3	-24.5	-28.7	-31.7	Ye June 30 (\$m)	2017	2018	2019e	2020e	2021e
Dividends	0.0	0.0	0.0	0.0	0.0	Cash	29.6	25.5	49.2	23.8	36.3
Other investing items	0.0	0.0	4.0	0.0	0.0	Loan receivables	98.4	239.1	501.9	966.9	1614.3
Share issues/(buy backs)	34.4	1.6	142.8	0.0	0.0	Other receivables	11.9	17.3	28.0	50.6	78.8
Other	8.1	142.6	25.1	0.0	0.0	PPE	4.5	4.0	5.2	5.2	5.2
Financing cash flow	42.5	144.2	172.0	0.0	0.0	Intangibles	52.9	48.9	46.3	46.3	46.3
Increase in cash/(debt)	-29.7	7.8	23.7	-7.5	28.5	Other	43.0	57.5	88.3	113.3	144.6
Cash at end of period	29.6	25.5	49.2	23.8	36.3	Total assets	240.3	392.2	721.1	1208.3	1927.7
						Payables	22.8	42.9	31.7	42.2	60.8
						Funding facilities	46.7	161.6	353.6	818.5	1466.0
						Interest bearing liabilities ex SPV	0.0	0.0	0.0	0.0	0.0
						Provisions	3.3	2.3	5.9	8.6	13.4
						Other	7.4	1.9	7.6	7.6	7.6
						Total liabilities	80.2	208.7	400.8	878.9	1549.8
						Contributed equity	171.4	192.6	356.4	356.4	356.4
						Total shareholders funds	160.1	183.6	319.4	329.4	377.9

*Note: Figures prior to including 2017 are reflective of Afterpay only. 2018 onwards reflects the combined Afterpay Touch Group. This excludes the balance sheet which is reflective of a pro forma estimate in 2017. Further disclosure changed from 2018 onwards.

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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Lafitani Sotiriou, authoring analyst, holds long positions in APT

Disclosure: Bell Potter Securities acted as co-manager of the \$117m August 2018 placement and received fees for that service.

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