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The PayPal Opportunity

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What's in your wallet?

Stealing the tagline from Capital One's popular ads…look at the credit and debit cards in your wallet. You might call them your Visa or MasterCards, but each is really a line of credit between you and a specific bank. That issuer can be JP Morgan, Wells Fargo, Bank of America or any of thousands of banks. Banks feel dis-intermediated from their clients, as the vehicle you use on a daily basis is not recognized as their valuable service.

A traditional wallet:

If you are anything like us, we still carry around wallets like George Costanza from the hit TV show *Seinfeld*.

Today, for everyday transactions, the plastic cards in your wallet still matter, and for many, cash and check remains a regular payment medium. With advances in smartphone technology, the traditional wallet is likely to change; however, over the next 5 to 10 years payment apps will to proliferate. Looking forward, the average consumer might put a half dozen favorite retailers' apps on their phones. Since most people do not want to clutter their beautiful iPhone's with 25 to 30 different apps, some merchants will get this valuable real estate because they offer great promotions or deals.

Smartphones:

The modern smartphone is a remarkable invention. An all-encompassing device that fits in your pocket, it can seamlessly do all the tasks that once required

separate technologies. It was only a matter of time before the payments industry began to think of better ways to utilize advancing technology and this wonderful device. The growing importance of the smartphone as the go-to computing device for every digital activity is the goal. Why not incorporate mobile payments and wallet technology into this powerful (always present) device?

Phones as wallets:

Technology is once again solving payment problems, and we need to recognize this change. The next change may be the most radical or impactful of all new payment advances. Many companies are attempting to use mobile wallets to eliminate the need to carry cash and plastic cards.

Powerful entities are attempting to acquire space on your phone. Phone manufacturers are rolling out products with Apple Pay, Samsung Pay, Google Pay and Android Pay. These networks have products like Visa's Check Out, MasterCard's MasterPass and PayPal. Banks are slowly getting involved, but many are afraid to spend millions investing in constantly changing technology. Currently, retailers have also followed suit. The Starbucks payment app has been wildly successful and it now represents 15% of all of its US purchases.

EMV (Europay MasterCard Visa):

In the US, EMV standards became effective in October of 2015. The goal was to lower counterfeit card fraud, by inserting a chip in all credit and debit cards. Still utilizing magnetic stripe technology invented in the 1950s, the US was the last remaining developed country to embrace chip technology.

MasterCard reports that 88% of its US consumer credit and debit cards now have an embedded chip. On the merchant side, the point-of-sale devices need to be equipped to process chip based payments. As of today, MasterCard estimates 55% of its merchant acceptance base has enabled EMV payments at their counters; Visa estimates merchant EMV acceptance at only 30%.

Liability shift:

Moving forward, counterfeit fraud costs will remain as the burden of entities with inferior technology. For example, the bank does not incur counterfeit card costs

if it has embedded a chip in its cards. On the flip side, the merchant does not incur counterfeit cards costs if it accepts EMV purchase transactions. The results have already been positive as Visa reports counterfeit fraud has decreased by 28% year-over-year. Over the last year, MasterCard stated that US counterfeit card fraud has fallen by 54%.

NFC (Near-Field Communication):
Most modern devices are already equipped with and incorporate NFC technology, which will ultimately lay the foundation for contactless payments. Why are many merchants choosing to wait to turn on mobile payments? Cost is one factor if terminals need to be upgraded. Some are waiting to determine which technology will ultimately win. Others are struggling with the vast array of certifications required to accept contactless payments. Merchants need to activate this capability latent in their terminals if they wish to allow for the future of mobile payments.

This shift in liability should act as a catalyst for the entire digital payments industry. As merchants accept chip cards, NFC technology will ultimately get enabled. As this happens, the number of locations where digital payment transactions can occur will dramatically rise. The tipping point is coming shortly as NFC becomes the dominant technology at most point-of-sale terminals. We believe that once mobile wallets become more prevalent, we will see digital payments increase exponentially.

Contactless:
The success of digital and mobile wallets depends on the ability to turn traditional point-of-sales devices into contactless payment terminals, which will allow consumers simply to wave or tap their devices at the point-of-sale. Some people will feel this is less secure than traditional methods of payments. However, one could argue that requiring a fingerprint scanner to unlock the phone represents more security than historical signature- based payments. When was the last time a clerk checked the back of a plastic card for matching signatures?

Marketing:
With contactless payment capability, merchants could materially improve traffic

and sales. Retailers could reach customers on their ever-present devices in real-time. Think of the functionality of sending a consumer an afternoon coupon for Starbucks as he walks or drives by a location. Think of the benefits to a consumer of keeping coupons or promotional offers automatically on his smartphone. Loyalty programs would be dramatically improved, as information about prior transactions and benefits would safely be stored online and on one's phone.

The rapid adoption of NFC and contactless payments has been hampered by the scarcity of locations where people can use the technology - the classic chicken or egg dilemma. A positive for the industry is that several entities are pushing for change. We believe that merchants will accept higher payment costs if they can generate higher traffic and improve sales. By enabling NFC devices in their stores, merchants have a chance to significantly improve and deepen the relationship they have with their customer base. There is a real return on investment with this initiative versus the branding costs of a TV, radio or magazine advertisement.

Whom do the payment networks work for?

We realize it might sound odd, but Visa and MasterCard really have no relationship with consumers. While both payment brands spend billions of dollars annually on marketing and advertising, it is for the benefit of their banking partners. The payment networks have agreements with various financial institutions and attempt to get their acceptance brand on the front of that card in our wallets. The fight to get that half an inch space of real estate on the bottom right-hand side of each bank debit or credit card is intense. We believe the payment networks work for the banks.

In the case of JP Morgan, some cards do not even have the Visa brand on the front. You can find that valuable Visa logo on the back, just to further emphasize - from JP Morgan's perspective - that it is *their* account. However, by building a brand that stands for safety, trustworthiness and widespread acceptance, the payment networks ultimately benefit.

Visa and MasterCard set interchange rates, which are the fees a card issuer can

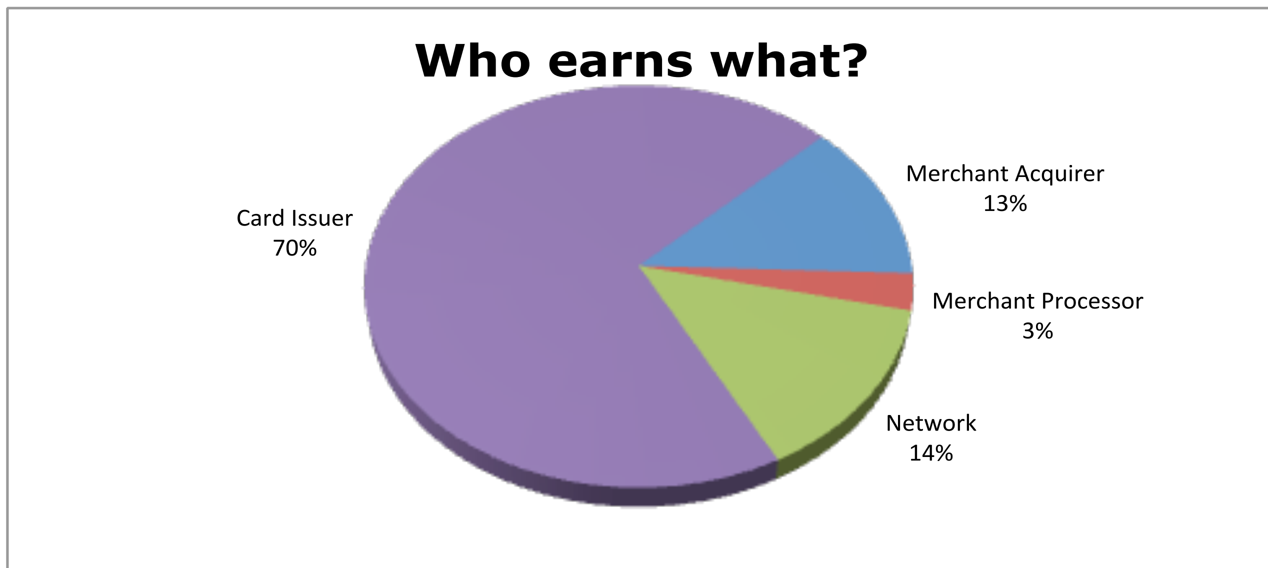
earn per transaction. The crux of many of the networks' legal woes is based on this particular fact. If Visa and MasterCard set the interchange fees, that is the key determinant of a bank's card revenues.

Merchant Discount Rate or MDR:
The process of completing a purchase transaction may seem simple (occurring in a few seconds), but various players participate in this complicated system. It starts with a merchant and a consumer. The average US credit card transaction is $88. On average, this transaction will generate $2.50 in fees split among 3 to 4 players. The merchant discount rate (called the MDR) is the total fee that a retailer pays to accept any cards. This total fee can be broken into separate pieces, since there are multiple players involved.

The bulk of these fees (roughly 70% or $1.75) go to the card issuer for accepting credit risk. This is typically the bank that has issued the card to the consumer, and is commonly referred to as credit interchange. The bank is taking on the majority of the risk, so it justifiably receives the bulk of the revenue allocation. Banks are making credit decisions on individual clients, providing a monthly line of credit. If consumers do not pay their balance in full, the bank earns interchange plus interest on the outstanding loan balance. If consumers pay their balance in full, the bank still earns interchange. The offset for this revenue typically funds reward programs, such as airline miles.

The remaining 30% or $0.75 per transaction goes to payment networks such as Visa or MasterCard and merchant acquirers/processors such as First Data, Vantiv or Global Payments. The majority of this fee goes to the acquirers and processors for their established relationship with the merchant. The smallest percentage of the transaction goes to the payment networks. These payment entities provide the critical components of each purchase transaction. They authorize, switch, clear, settle and provide valuable tools like fraud and risk

management. The behind-the-scenes payment processing gets handled by multiple players. Their job is to handle all types of payment transactions quickly and securely. While the merchant settlement process is complex, these payment players handle billions of transactions and trillions of dollars.



The digital payment industry is complex and various players are involved in the processing of one purchase transaction. The "supply chain" is changing and various market participants are vying for their place in the process. Acquirers, processors, issuers, gateways, banks, networks and hardware and software players are involved in this complicated ecosystem.

PayPal's model:

PayPal (like its payment network peers) generates most of its revenue by taking a little piece of the price of every purchase processed through its platform. This "take rate" typically runs $0.30/transaction plus 2.9% to 3% of the purchase price. Rates can vary depending on the type of merchant, whether a card is present (in-store or online) or the ultimate funding source (credit or debit). If a purchase is similar to a traditional credit card transaction, PayPal will pass-through or pay out 2% of its gross revenue. The margins are obviously much less with these transactions. If a transaction uses PayPal's debit connection with a consumer's bank account, revenue and margins are much higher.

As business continues to evolve, we have seen the primary device change from the PC to the smartphone. PayPal has adapted, but so have other players. Visa and MasterCard are developing similar online products to replicate PayPal's online presence. Once again, it is the financial institutions providing the credit that immediately benefit, but the payment networks receive the long-term rewards.

Banks favor card usage because it generates revenue and income from their customers. Usage of the ACH network incurs a cost for banks in terms of lost revenue and added complexity. In the event of a chargeback or problem, the bank and card issuer receive the angry phone call, rarely PayPal.

PayPal's history:

To enable seamless eCommerce or online transactions, a payment middleman needed to exist. Credit and debit cards were the only mechanism to transact and PayPal was the first to truly understand the opportunity. Instead of requiring 16 digit codes, validation dates and security codes, PayPal created a bond with the end consumer. It created simple and easy buy buttons, which required only a passcode. PayPal simplified the process to conduct commerce and they garnered significant first mover advantage.

In the early days, PayPal lured consumers with $10 to sign-up for an account. Early adopters signed up for PayPal and made one of two choices. They could tie a credit card to their PayPal account or they could input debit information and

allow PayPal to act as a pseudo debit account. The tie-in with credit cards was costly for PayPal (ie: low margins), while moving funds via Automated Clearinghouse or ACH was fractions of a penny. Obviously, PayPal preferred the debit route and steered its consumers towards this type of tender.

eBay:

After a brief stint as a public company, PayPal was purchased by eBay in October of 2002 for $1.5 billion dollars. eBay wanted to solve two key issues. The first concern was sustaining its growth. PayPal generates revenue per transaction and this predictable revenue stream benefited eBay. The other issue was getting shoppers to finalize their transactions. With its simple "buy now" button, eBay could lower its cart abandonment problem. eBay pushed PayPal as its preferred choice for payments, and the result was an explosion of users and volumes.

Merchants:

PayPal has tried and failed to take its business from online into the physical world. It signed an agreement with Home Depot in October of 2014 to allow PayPal transactions in its stores. The goal was to allow consumers to conduct transactions by entering their phone number and a passcode at the point-of-sale terminal. This failed to get much usage and was dissolved. While PayPal has garnered significant market share of online transactions, it has had difficulty bridging the divide online and physical retailers.

Another attempt at solving its physical acceptance problems was PayPal's agreement with Discover in 2012. The goal was to get PayPal merchant access at 7 million US Discover locations. PayPal sought to leverage Discover's payment network and merchant acceptance to improve its physical, in-store presence. First Data, one of the largest merchant acquirers, essentially prevented this deal from succeeding. This example indicates how complicated the payment process is and how difficult it is to become a globally accepted payment network.

Visa and MasterCard noticed PayPal's online strength and were investing heavily to create a similar offering. The traditional payment networks were moving

online, but PayPal was struggling to move downstream - back towards physical retailers.

Spinning from eBay:

In the summer of 2015, PayPal once again became a publically traded company (ticker PYPL). There are many examples of companies that have spun out from parents and gone onto big success. In his book "*You Can Be a Stock Market Genius*", Joel Greenblatt highlights how to profit from corporate spin-offs.

In our opinion, PayPal needed to break away from eBay for a few key reasons. First, PayPal needed to make serious investments in its future. As part of eBay, it would need to fight and make a corporate case for such investments. Secondly, PayPal is still in its infancy as a brand. While it has been in existence for less than 20 years, PayPal has yet to reach mass adoption. While half of transactions are outside the US, most accounts are US-centric. Not only does it lack global acceptance, but PayPal's 188 million active accounts are roughly 5% to 6% the size of those of traditional card issuers. Visa and MasterCard are accepted in twice as many countries as PayPal. In addition, PayPal has 14 million global merchants, only one-third the acceptance rate of Visa and MasterCard.

PayPal, like all payment networks, is built for leverage, not the balance sheet type of leverage, for PayPal has $5 billion or $4 per share of cash (and no debt). The leverage we are referring to is network scale. Once a global presence is built, the network can leverage its scale and drive margins. PayPal has invested in the network and is creating deals to build transactions and volumes. To grow its base of users, PayPal must invest in its brand and create a similar awareness as the traditional payment networks enjoy. It must be safe, secure and trustworthy. Last quarter, PayPal generated 1.4 billion transactions, up an impressive 25% year-over-year. In our opinion, this transaction figure is the key metric to monitor and analyze. In order to build volume, it needs to gain acceptance, not just online, but in the physical marketplace. This is our primary takeaway from PayPal's recent agreements with Visa and MasterCard.

Creative Destruction:
In 1942, Joseph Schumpeter discussed the term "creative destruction" in "*Capitalism, Socialism and Democracy*". Essentially, it reviews the theory of "incessantly" destroying and then creating a revolutionary and better product. Through innovations, a new organic process is created from de-constructing prior, long-standing arrangements. In modern economics, this evolutionary process ultimately frees up resources to be deployed elsewhere.

Recent agreements:
By its very nature, the philosophy of creative destruction treats economics as a fluid and dynamic process. The recently signed distribution agreements between PayPal and both Visa (July) and MasterCard (September) create more questions than answers. PayPal fell 7% the day of the Visa agreement and the market was quick to proclaim its prospects dire.

In the press release, PayPal claimed that it "will not encourage cardholders to link to a bank account via the ACH." As we discussed above, the most profitable business for PayPal is its debit or ACH-linked transactions. The agreement with Visa and MasterCard provided ammunition to the bears. When PayPal's CFO John Rainey suggested that 2017 transaction expenses would increase from this funding mix shift, the market worried. The market is concerned that higher margin debit transactions will decline and PayPal will be forced into more credit card-based transactions, with their higher interchange rates. Just because PayPal provides great access and "clear and equal payment options" for Visa and MasterCard products does not mean that its favorite transaction will go to zero. PayPal built its history on the success on leveraging the low-cost ACH network. While it will not be at the top of the page, ACH will still be offered and used.

Our thesis:
Should PayPal be willing to accept lower margin card purchases as long as its transaction volume dramatically increases? We believe the trade-off is positive because these pacts will have long-term benefits for PayPal. PayPal hopes to increase its purchase volumes and physical payment market share. Also, it removes the worry that it was on a collision course with the global payment

leaders. Thus, PayPal management is creatively destroying one business to further its success in another. The logic was that as long as PayPal continued to pass through the interchange for funding tied to credit cards, its margin would be permanently capped. We disagree with this thesis and believe these agreements will actually benefit all parties. On a go-forward basis, PayPal will not push ACH transactions above Visa or MasterCard card-linked accounts. It does not mean that all transactions will bypass the bank-linked (ie: better margins) process. PayPal will receive numerous positives for this "creative destruction."

Increased acceptance:

Quite simply, the long-term distribution agreements improve PayPal's physical point-of-sale presence. The new agreements allow PayPal to get access to any contactless point-of-sale terminal if that device has up-to-date security, encryption capabilities, and if it uses tokens for transactions. While the base of those accepting contactless payments is growing, it currently covers 5 million global merchant locations and about 1.25 million here in the US. This point is critical for PayPal's migration from online only to the in-app and in-store mobile wallet. By using Visa and MasterCard's tokenization service, PayPal will be able to significantly expand its point-of-sale presence and acceptance. We liken these deals to all the children in the sandbox agreeing to play nicely. The payment networks are agreeing to cooperate to advance digital payments, as opposed to having turf battles. We expect to see PayPal's digital wallet, powered by Visa's Digital Enablement Program or MasterCard's MasterPass security. Instead of working on complicated and bi-lateral commercial contractual deals, PayPal will leverage technology and the de-facto standards created by payment networks. In terms of ubiquity, we believe the security measures taken by Visa and MasterCard will be widely used, independent and neutral. PayPal will easily request a secure token and enable contactless in-store payments. The head of Visa's token service recently said, "it gives the merchant the ability to choose whether at the point-of-sale the consumer presents a QR code or an NFC radio signal or a BLE beacon-enabled transaction, because VDEP is agnostic."

The agreement will allow PayPal to sell these tokenized transactions to merchants at competitive rates. It can offer volume incentives and fee certainty. Finally, PayPal believes it can profitably go offline and compete with anybody at

the point-of-sale.

Card Issuers:
Banks are always looking to build strong and lasting relationships with their customers. Card payments are daily interactions between a bank and its consumers. As consumers use their line of credit (or debit account), banks generate volume and transactional revenue, which can be in the form of plastic cards in a current wallet or in digital form in a mobile wallet.

Card issuers like Bank of America, Wells Fargo, or Chase have several options. These large banks could invest significant money to create a payment app specifically for their cardholders. For example, Chase has recently launched Chase Pay and it will be available where Paymentech (its merchant acquirer / processor) has merchant relationships. In addition, card issuers rely on their designated payment networks to develop such an app. For example, a smaller bank could utilize Visa Checkout or MasterCard Masterpass on a white label basis. One last option for issuers is to vie for primary positioning on widely issued mobile wallets. This is a critical aspect for PayPal because the issuer with a primary position in the mobile wallet will succeed. The card at the top of the mobile wallet should garner the majority of future digital purchase transactions.

Phone manufacturers like Apple and Samsung are device and operating system dependent, but PayPal is independent. We think it has an opportunity to become the “Switzerland” of the mobile wallet world. On future payment methods, issuers will have the opportunity to opt-in and become a digitized, tokenized card in a consumer’s PayPal mobile wallet. For example, this would allow Bank ABC and its issued Visa or MasterCard to get utilized in a consumer’s PayPal account. We like models that are open-ended and provide unlimited choice. We anticipate consumers loading any credit, debit or gift card they choose into their PayPal digital wallet. PayPal wallet holders will be able to conduct online transactions, as well as have functionality for in-store purchases. We believe this will be an inflection point for PayPal’s transaction volume. We expect PayPal, Apple Pay and Samsung Pay to offer early incentives for certain issuers to get primary placement and positioning in their mobile wallets. In addition, one should expect issuers to offer promotions to cardholders for merchant specific use.

Larger financial institutions should pursue all three options. Smaller banks should attempt to leverage their designated payment network and choose the last two options. There is no correct answer, but it is not too late to adapt to change. To quote hockey great Wayne Gretzky, "You miss 100% of the shots you don't take." Banks should attempt to be present in any digital checkout option and try to avoid placing bets with just one player. The end goal is to drive transaction volumes in a store, online or in an app. Smart issuers are incentivizing consumers to transact and trying to build an early lead.

One might think that PayPal's success comes at the expense of another entity. Some claim that PayPal specifically damages the card issuers and hurts their interchange model. PayPal's new agreements actually could improve volumes for those card issuers willing to change and adapt. PayPal's CEO Dan Shulman stated, "We've been in discussions with issuers. They're excited about the volume we can bring to them. This agreement removes many of the concerns issuers have about working with PayPal." This certainly is PayPal's hope.

Fees:

Another benefit for PayPal is a reduction in future fees/expenses. Ever since 2013, MasterCard has instituted a fee specifically targeting PayPal. Called the "staged digital wallet operator annual network access fee," it is a long-winded name for a fee directly targeting PayPal's success at using the ACH network and bypassing bank issued cards.

Since the ACH is not a user-friendly platform, it can create nightmares for issuers. With their vast back-office call centers, banks are often ill-equipped to handle chargeback or payment questions from linked PayPal accounts. Banks were not receiving proper revenue contribution from transactions but were receiving an increasing level of client frustration.

MasterCard's logic (since it was protecting its bank partners) was to institute a fee for transactions that bypassed its payment rails. MasterCard believed that this fee would protect its issuers and penalize PayPal for leveraging the payment network without properly paying for this access. The new MasterCard and PayPal agreement terminates the digital wallet fee.

Pricing opportunity:

For this equal access, PayPal will receive undisclosed volume discounts from the networks. PayPal will receive certain financial volume incentives, which should help it ultimately boost margins. These are volume discounts should grow in size with corresponding transaction growth. As volumes increase, merchants benefit as well. Merchant acquirers and processors will eventually add PayPal's brand to their acceptance offering. Over the last few years, acquirers have begun to add American Express to their suite of accepted cards. Merchants received economic incentives which resulted in American Express getting better retailer acceptance and volume growth. PayPal would be wise to follow this game plan.

Circular benefits:

Over the next few years, we expect to see PayPal grow its global merchant acceptance by negotiating separate deals with payment networks as well as with merchant acquirers and processors. A key tenet to our thesis is that PayPal's mobile wallet will become one of the few winners and options in the digital payment landscape. The circular benefits seem obvious to us. PayPal will leverage its positioning with nearly 200 million active users. As its base continues to grow, transaction volumes will improve. Volume growth will lead to higher incentive payments and allow PayPal to reap scale advantages, which will lead to higher incentives to pay out to retailers for better merchant acceptance. PayPal's CEO Dan Schulman is often quoted as saying that his company is focused on "consumer choice." Following the MasterCard agreement, Schulman said, "With each partnership agreement that we sign, we further expand the ubiquity and value of the PayPal brand and improve our own economics."

Person-to-Person (called P2P) payments:

According to a recent MasterCard study, over 95% of all person-to-person transactions are completed with cash or check. PayPal's long-term goal is to help consumers move money in a seamless way. A key growth initiative for PayPal is to push in person-to-person payments. Venmo was a valuable asset PayPal received in its November 2013 $800 million acquisition of Braintree. Venmo, a dominant person-to-person platform, is quite popular with millennials. This digital wallet allows consumers to send money with a simple text on their smartphone. In July 2015, following its spin from eBay, PayPal acquired

Xoom.com for $890 million to further strengthen its money transfer capabilities. Both these deals clearly indicate that PayPal has a large commitment to growing its person-to-person franchise. Xoom.com has a strong presence in money transfers and has important licenses in key countries like India.

The P2P payments business benefits PayPal in two ways. First, it attracts a growing demographic of active users. Secondly, it builds scale advantages and volumes. PayPal believes that generating volume and loyal customers outweighs the benefits of this segment's current profits and serves as a long-term investment and opportunity for PayPal. We are still a few years away from mass adoption, but the millennial generation is rapidly embracing mobile peer-to-peer payments. Estimates are calling for the US person-to-person market to grow from $5.6 billion in 2014 to $175 billion by 2019. Consumers continue to love convenience and embrace the vast capabilities of their increasingly powerful smartphones. We believe volumes and transactions will ultimately lead to profits for this segment. What is currently an investment and cost, will ultimately lead to earnings contributions and an increase of PayPal's overall valuation.

The recent deals with Visa and MasterCard could leverage the PayPal P2P assets. Millennials, who are less likely to work with traditional banks, can easily move money via Venmo. Funds can be loaded onto a debit card or simply deducted from a checking or savings account. The combination of Visa's leading debit network plus PayPal's Venmo app is intriguing. Visa Direct is a service that enables fund transfers using a Visa debit card. The Visa partnership will allow cardholders to utilize the Visa network to make real-time transfers from a PayPal or Venmo account to their bank account (and vice versa).

The MasterCard and PayPal deals highlighted some interesting statistics. The agreement requires that PayPal's wallet include digital representations of the users' registered MasterCards. PayPal can now begin to tap a deep new transaction base. We like the opportunity of marrying MasterCard's impressive US account base (164 million credit and 185 million debit cards) with PayPal's mobile wallet. This should drive point-of-sale purchases transactions using all types of MasterCard accounts.

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What Wall Street Is Missing:

The sweeping, multi-year agreements with both Visa and MasterCard create an interesting opportunity. The market is punishing PayPal because it believes the traditional payment networks have won the battle. We believe these deals mark a thawing of a frosty relationship. Visa's CEO Charlie Scharf aptly described the agreement with PayPal as an ending of a "frenemy" or "co-opetition" relationship. Nobody ever believed these companies were friendly.

PayPal's digital wallet is clearly a threat and both networks wanted access to it. PayPal wants to boost its transaction volume and now has opened massive global and physical acceptance. In addition, PayPal receives scale benefits and valuable financial incentives. Instead of battling each other, all three companies are agreeing to collaborate to advance the digital payments marketplace.

With the signing of these two deals, PayPal has cemented itself as one of *the* digital payment winners and has proven its value in the payment ecosystem. This is why both traditional network brands chose to work with this digital payment leader. While PayPal is not perfect, we see more opportunity than risk. To become a digital payments leader, one needs to build scale and provide multiple options. PayPal is cloud-based and works across all relevant operating systems. It works online, in-app and now in stores. PayPal owns various assets including Braintree, Venmo, Paydiant, Xoom.com which take it across various platforms. Will all of these assets be wildly successful? Probably not, but a digital payment leader needs to be taking risks.

PayPal has shifted its business model to driving transaction volumes. It can be online, in an app or in a physical store. It can be person-to-person or on its mobile PayPal wallet. This is a volume game and new management of PayPal understands this. The goal is to drive as many transactions across its scalable platform as possible. As a part of eBay, PayPal was the asset responsible for driving growth. Now that it is on its own, it can focus on making key long-term investments, without the fear of damaging eBay's profitability. PayPal generates excellent free cash flow of $500 million per quarter, which will allow it to make these critical investments. Management understands that to drive future growth, PayPal must grab valuable real estate in people's mobile wallet. Eventually, a

loyal customer base will allow volumes to scale. Margins will rise and there will be a protected franchise, offering ubiquity and choice. It is our opinion that this is a volume game across every channel and every payment type.

Valuation:

Following its spin from eBay, PayPal's valuation was immediately compared to those of Visa and MasterCard. We understand this but feel it is somewhat unfair. In our opinion, both Visa and MasterCard are superior companies and business models. We understand that not all investors will make room in their portfolio for all three companies, but we have no problem concentrating our holdings in excellent, long-term growth stories. Looking at these "Big 3," the most noticeable difference is operating margin. The margin structures of both Visa and MasterCard are materially higher. In the most recent quarter, Visa's operating margin was an astounding 68% while MasterCard's remain in the mid 50% range. In comparison, PayPal's operating margin was below 20%.

We want to be very clear and state our real appreciation for both Visa and MasterCard's business models. They are truly wonderful businesses and the future for both is promising. We are large shareholders of both and believe the opportunities for future growth are quite promising. In the case of PayPal, we also see vast opportunities. Now independent from eBay, management can create new partnerships and make significant and necessary investments. We believe PayPal's growth will continue to be an industry leader and there are opportunities for operating margin expansion.

For comparison purposes, we always like to start an examination of market capitalization and enterprise values. Visa has a market cap approaching $200 billion, MasterCard has a capitalization of roughly $110 billion, while PayPal is much smaller at $45 billion. Considering it is much smaller, PayPal should be growing much faster. All three have net cash on their balance sheet, with Visa only recently taking on debt following its acquisition of Visa Europe. In terms of Enterprise Value to EBITDA estimates, there is little variation to identify. All are roughly 12x forward EBITDA estimates. Looking at Price to Earnings or P/E estimates, we believe we can best frame the payment network players. Both American Express and Discover are card issuers and therefore accept credit risk.

Both attempt to provide transparency into their opaque balance sheets, but we believe the models are fundamentally different. They are peers, but not terribly relevant for this comparison. Both American Express and Discover are struggling to grow and have been invisible in the digital payment world. Others tend to lump the payment acquirers and processors as relevant peers. We agree that these business models are also predictable and generate they recurring revenue, but they are much smaller. We prefer the "Big 3" of Visa, MasterCard and PayPal for this P/E comparison. In terms of valuation, Visa trades at 24x calendar 2017 estimates and the market is expecting low double-digit revenue growth and mid-teens earnings growth. With its acquisition of Visa Europe, these numbers should be attainable. MasterCard trades at 21x calendar 2017 estimates and the market expectations are for double-digit and high-teens top and bottom line growth. MasterCard is lapping some difficult comparisons (the loss of USAA) and client losses, so results should also surprise to the upside. PayPal is trading at 21x next year for mid-teens revenue growth and high-teens earnings growth. The market has more uncertainty concerning PayPal's ability to deliver. Not only does PayPal have a shorter tenure as a public company, but its recent agreements also cloud the margin expansion story.

We expect PayPal to deliver earnings next year in the $1.85 per share range. Applying a low 20x forward multiple, we get to ~$45 per share. At $40 today, that implies solid upside in the low-teens range. 1st Call or Wall Street estimates are anticipating 18% growth in PayPal earnings next year. By simply rolling forward its current P/E by one year (assuming it can keep that valuation), one could expect mid-to-high teens price appreciation. In terms of next year's earnings, we are taking CFO John Rainey's words as pseudo guidance. He said, "The deal has laid the foundation for revenue growth with more certainty in our cost structure."

We never invest with the hope that one of our companies gets acquired. That being said, PayPal has positioned itself well for future growth. If Apple, Google or another large entity struggles to gain traction with its payment offering, we would not be shocked to hear acquisition rumors. In this scenario, PayPal's unique set of assets would easily get a Visa multiple, implying a 25x forward P/E. This would imply a price target approaching $50 per share or over 25% upside.

Google:

One of our bigger picture questions remains. As one of the world's largest companies, when will Google deliver an interesting payment play? At the latest iPhone 7 launch presentation on September 8th, Apple claims that its Apple Pay handles 90% of all mobile wallet transactions. Google, with its Android operating system and vast array of assets (search, maps, YouTube, etc) has yet to make a dent in payments. Google's focus on Android Pay has been too limiting, as this is really viable only on those devices using its operating platform. We would like to see Google make a strategic push to embrace PayPal's independent mobile wallet; it should integrate all of its assets with PayPal and see its share of volumes lift. It may not earn the vast majority of the payment economics, but it would be integrated into the valuable data flow of purchase transactions. We believe this meshes well with Google's core strength – search.

Conclusion:

Once Visa finalized its deal with PayPal, MasterCard was quick to follow. PayPal is migrating from an online-only, ACH-based payment company to a fully capable digital wallet. We believe these agreements cement PayPal as one of only a few viable, independent digital wallets. It is our opinion that Visa and MasterCard benefit under these new terms. All three parties bring something to the deals. Visa and MasterCard bring global acceptance, wonderful brands, millions of consumers and their financial institution partners. PayPal brings the largest digital payments network and nearly 200 million engaged users. PayPal has a market leading digital wallet and we believe it has a great opportunity to leverage the powerful payment engines and assets of both Visa and MasterCard.

With great growth prospects and a newly focused (and spun) management team, PayPal is poised to succeed. Is PayPal a cheap stock? Is it a Benjamin Graham value play? We would say "no," but companies with these growth rates and prospects rarely are. If PayPal's stock continues to languish, it has the potential to become an activist target or potential take-out story. In our opinion, the recent agreements with Visa and MasterCard have created an opportunity to purchase PayPal at a slight discount. The combined cardholder base of these traditional payment networks, coupled with PayPal's attractive account base, should be powerful. Merchants are always looking for ways to drive traffic, improve sales,

and lower costs. PayPal can now alter the digital payments process and shopping experience. At least that is the long-term hope….

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