2nd Quarter 2020 Investor Newsletter – Part 2 ½

April 2020

MANOLE CAPITAL MANAGEMENT

Introduction:

At Manole Capital, we focus all our time on FINTECH, or doing bottoms up, fundamental research on financial and technology companies. In our normal quarterly newsletters, we provide some macro commentary on interest rates, inflation, Fed actions, and touch on some items impacting the FINTECH industry. There is so much going on right now, that we broke our newsletter into 2 separate components. Part 1 focuses on the macro issues, unemployment, Fed actions, and our attempt to frame the economic and financial damage this virus is causing. In Part 2 ½ (an ode to Naked Gun 2 ½), we highlight our thoughts on risk, being prepared for volatility and we have sprinkled in a few tidbits about some of the long-term ramifications, both positive and negative, for our FINTECH stocks.

Information:

Normal recessions do not just upend the economy, but they typically "clean out" any excesses. Our early read on this virus is that two of the overall winners will be technology companies, as well as high-quality growth companies. Luckily for us, these are heavily weighted in our portfolios.

Over the next several weeks, as companies begin to report 1st quarter results, it will be critical to listen to management teams and gauge whether or not they have a good grasp of their fundamentals. Do these management teams and companies have a plan forward? Do they have the capital needed to survive this downturn? How are they positioned for the next 3 months or the next 3 years?

Sell-side analysts crave insights from their covered companies. Anybody can build a model in Excel forecasting future results, but most outcomes and estimates fall in-line with company guidance and expectations. Right now, companies are dealing with the unknown and many companies are not being forthright. Some management teams will discuss earnings power and capital needs, while others will simply remove 2020 guidance and say, "We don't know."

We believe public companies should disclose to shareholders their plans and strategies for dealing with this crisis. SEC Chairman Jay Clayton recently said investors are "thirsting for information" and "companies should be telling the market where they stand from a capital needs perspective." This is a fundamental shareholder right, but many companies will shy away from being so open and transparent.

Over the last 5 to 7 years, most analysts built models focused on revenue and growth rates. It seemed that revenue growth and the income statement was the primary focus. While capital was abundant, there was little commentary or analysis of the balance sheet or cash flow statement. Well, this certainly has changed. Manole Capital has always focused on free cash flow and the financial strength of our companies. One never knows when the capital markets window will close and businesses will be forced to operate without the help of the capital markets. This is where we are today…

Told Ya:

We were not expecting this crisis and neither were 99.99% of all investors. We were anticipating higher volatility, as we discussed in our 1st quarter newsletter (click here), but that was election related, not due to a global pandemic. While we weren't expecting this environment, we have been preparing for this type of volatility. How? By stress testing our models for awful circumstances and trying to understand the ramifications of what we call our *"angry bear"* scenarios. Over the last several years, we heard dozens of investors talk about how they were "praying for a downturn", so they could finally get invested. We wonder if these same investors are actively buying or are they once again waiting for a better price?

In the event you hear someone on CNBC or the news highlight how they predicted this crisis, it probably makes sense to consider this "Told ya" chart. Did these "experts" sit out this decade long bull market for their "moment in the sun"? If they did, those investors missed out on a +400% return.

The Intelligent Investor:

The Intelligent Investor, by Benjamin Graham is considered by Warren Buffett as the "most important book ever written on investing". Graham advocated that intelligent investors just needed to be patient, independent and show some self-control. While a speculator is mainly interested in "anticipating and profiting from market fluctuations" an investor is interested in acquiring and holding suitable investments and does not have a meaningful interest in price fluctuations; investors see this as "an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal."

He also stated that if you are an investor, rather than a speculator, it is best to figure out whether or not you are "enterprising" or "defensive". The "enterprising" investor is willing to "devote time and care in an attempt to outperform", while the "defensive" investor wants to "avoid severe mistakes and losses". Speculators are in thrall to the mythical, moody figure known as Mr. Market. Mr. Market is always available to trade, either to buy your stock or sell you more. Much of the time, Mr. Market sets prices that are sensible, but sometimes he puts ridiculously high or low prices on stocks. Surprisingly, many people become more eager to trade with Mr. Market as his prices become more chaotic.

We strive to follow to Graham's advice and be "enterprising investors". "You don't have to let Mr. Market do the thinking for you. The true investor scarcely ever is forced to sell his shares, and at all other times he is free to disregard the current quotation."

Warren Buffett's "right hand man" and Vice Chairman of Berkshire Hathaway is 96-year old Charlie Munger. Charlie is humorous and always to the point. We recently saw a *Wall Street Journal* interview he gave and found some of his comments in-line with our thinking. Munger began the conversation stating that he believes one of the great keys to investing is "sitting on your ass." While we wouldn't necessarily agree with this statement, there is something to not trading, simply for trading's sake. We believe Munger was hinting that doing nothing the vast majority of the time isn't necessary an error and that buying aggressively is fine, as long as it's at bargain prices.

Munger said, "we're like the captain of a ship when the worst typhoon that's ever happened comes. We just want to get through the typhoon, and we'd rather come out of it with a whole lot of liquidity. We're not playing, 'Oh goody, goody, everything's going to hell, let's plunge 100% of the reserves into buying businesses." He believes that many business leaders are simply "frozen" and that there are companies that simply don't know what to do because "they've never seen anything like it. Their playbook does not have this as a possibility."

As to the current environment, Munger said "Of course we're having a recession. The only question is how big it's going to be and how long it's going to last." Munger would not even hasten a guess as to how long this downturn might last or how bad it could get. "I think we do know that this will pass. But how much damage, and how much recession, and how long it will last, nobody knows". He closed the interview by saying "This thing is different. Everybody talks as if they know what's going to happen, and nobody knows what's going to happen." I don't have the faintest idea whether the stock market is going to go lower than the old lows or whether it's not. We have to live through this and let the chips fall where they may." That's classic Charlie!

Risk:

Some measure risk by asking for standard deviations, volatility, Sharpe ratios or R-squares, but we have a more basic definition of risk. We view risk simply as how much of our own net worth we are willing to just throw away. Those that know us personally, know that we are "fiscally sound" or sometimes plain ol' cheap! In other words, risk equals a permanent loss of capital, which is something we are <u>not</u> fond of. While we appreciate these risk measures, we prefer to own companies that we have covered for decades.

As long-term investors, we can accept short-term price fluctuations in exchange for long-term returns. We value capital preservation and strive to deliver superior risk-adjusted returns over time . We will bypass today's hot trend, to stay focused and disciplined on our niche – FINTECH. We are not a mile wide and an inch deep, but the opposite. Our detailed knowledge, on our holdings, is one basic definition of risk. Our loyal readers know we love quoting legendary investors like Warren Buffett. While we aren't 100% onboard with his quote on risk, there is some merit to it. Buffett said, "keep all your eggs in one basket and watch that basket closely."

During this decade long bull market, many investors have forgotten what "real risk" is. During the Financial Crisis, we came to the unforgiving realization that the financial sector is just different from most industries. What do we mean? A manufacturer or industrial company has a tangible factory or real assets on its balance sheet. There is inventory that has a real worth, even if a temporary buyer isn't there. In the financial sector, it is very different. The assets are the people that go up and down the elevators each

day. For financials, the real measure of risk is found by analyzing the balance sheet, especially those liabilities. One must understand these opaque liabilities because assets can be immediately marked-to-market at much lower prices.

During the Financial Crisis, we saw numerous companies essentially become worthless, from Bear Stearns to Lehman Brothers to Fannie Mae or Freddie Mac or AIG. Maybe worthless is too harsh a statement, as there was some value post the crisis. But many would have gone bankrupt, if not for the Fed and Treasury bailout. However, the lesson is that financials are different; financial stocks can and sometimes will approach a valuation of zero. This makes understanding the risks and what sits on the balance sheet critical.

You Cannot Predict, but You Can Prepare:

Webster's definition of preparation is "to make ready for some activity, purpose or use." While it isn't the official motto of the Boy Scouts, we like their written goal (from 1908) which states "always be prepared" and "be in a state of readiness, in both mind and body, to do your duty."

Very few investors were prepared to go from all-time highs to entering a recession overnight. Many industries have been preparing for a slowdown, but they got a total shutdown instead. A downturn can be prepared for; a shutdown is entirely less manageable. We liked Jamie Dimon's comment on JP Morgan's 1st quarter conference call. He said, "Entering into a crisis is not the time to figure out what you want to be. You must already be a well-functioning organization prepared to rapidly mobilize your resources, take your losses and survive another day for the good of all your stakeholders."

As a boutique asset manager, we have preached to clients and prospects that we are built to withstand difficult environments and our portfolio is capable of weathering potential storms. While we never could have envisioned the damaging impact of this COVID-19 outbreak, we have positions in the portfolio specifically benefitting in this environment. While many of our payment names have been impacted from the dramatic fall-off in consumer spending (more on that later), some of our exchanges and transaction processors have benefitted from eye-popping volumes. For us, we usually discuss volatility as a positive. What do we mean?

We are heavily invested in the exchange space. These companies provide market participants an ability to connect and trade various financial instruments, at all times of the day, across the globe, with transparent market prices and near instantaneous liquidity. This is a unique and valuable service that requires a tremendous amount of capital to build. Once in place, these exchanges can almost be impossible to encroach, especially if they are built with stringent, rules-based clearinghouses. In this environment of volatility, we believe our exchanges and their low capital, agency-like business models will thrive.

Whether it is a downturn (like now) or an upswing (like the last 10 years), our portfolios are structured to handle instability and uncertainty. With the coronavirus outbreak, we have seen markets plummet, unemployment spike and many managers are now scrambling to adapt and react. This can led to concern, confusion and unanswerable questions from clients, but we have been trying to *over*-communicate.

We are not experts on many of these healthcare issues or when these pivotal medical questions will be answered. However, we can rely on our disciplined investment process. We believe that only the strongest companies will survive and be able to “weather this storm”. We have the right systems and processes in-place, before this major market movement occurred. We are going to look forward, lean on our scenario-based modeling and forecast which businesses are going to survive and then thrive, versus those that cannot withstand this environment. We are prepared for volatility and have successfully managed this crisis so far. The evidence is in our performance results, especially during periods of heightened stress…

What Actions Are We Taking?

One tactical action we have implemented is increasing our cash balances and “circling the wagons”, especially on our long-only portfolios. We run very concentrated portfolios, but we have parted ways with a few of our smaller names and smaller market capitalization FINTECH companies. These are fine companies, with solid long-term prospects, but we feel this environment forces us to only own excellent companies, with fortress balance sheets and exceptional short and long-term prospects. Across all of our portfolios or various “flavors” of FINTECH, we are at near record levels of cash. We feel it is prudent to have a little more cash than normal, especially in this volatile environment. We remain “fully invested”, but these elevated cash balances allow us to buy names we like, when Mr. Market throws them away. In this environment of panic selling, we are reminded of one of Warren Buffett’s great quotes. Buffett said, "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."

We enjoy Twitter and news channels as much as the next guy, but it sure seems like both are engineered to maximize panic. Calm and rational thought is often penalized, just as panic seems to be amplified. If you find yourself spending too much time on Twitter or watching the news, just be careful. We aren’t saying the 1950’s or 1960’s were better, as we received all of our news from only three networks. However, it seems like cable news and Twitter have discovered that panic is a great way to get viewership, drive users, “eyeballs” and make a profit. We aren’t sure that all of our media is making things better. Maybe some are just spreading anger and fear? Just a thought…

Surveys / Payment Preferences:

For the last three years, Manole Capital has worked with a number of interns. One of their projects has been to conduct a survey, primarily of their Gen Z generation, and to better understand their perspectives on banking, brokerage, payments and digital currencies. Our 2020 survey results will be ready shortly, but here’s a quick link to last year’s notes (click here).

In our payment note, we will try to gauge how Gen-Z prefers to pay for goods and services. We recently saw a FreedomPay and Ingenico survey, which covered the US market, pre-coronavirus. It found that 18% of the US preferred to pay in cash, while 82% preferred other forms of credit / debit payments (example: 54% prefer to

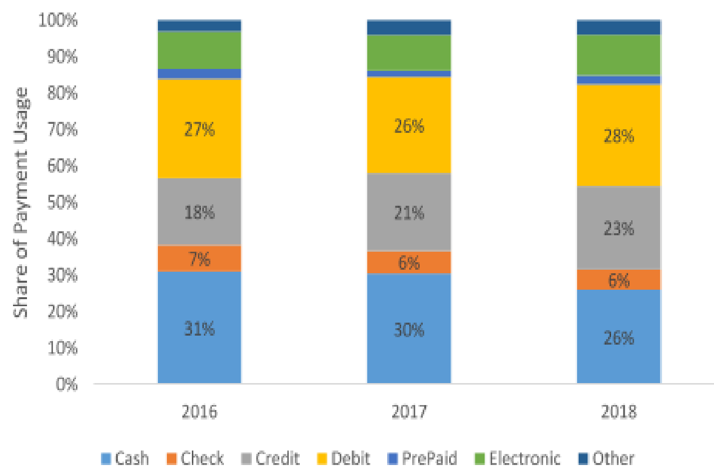
insert an EMV card, 11% like to swipe their magnetic stripes, 7% contactless , 4% digital wallet, etc). Over the next couple of weeks, check www.manolecapital.com/research to view our team's 2020 Gen-Z survey research.

Does "Cash is King" Still Apply?

Many have heard the expression "cash is king". Being about to produce free cash flow, to sustain a business through difficult times, is critical for survival. However, we want to begin to discuss the ramifications of COVID-19 and the impact it will have on our payment businesses. We have always felt that the payment sector is the quintessential FINTECH business. Our definition of FINTECH is "*anything utilizing technology to improve an established process*" and the secular growth of payments perfectly fits in this niche. These payment companies generate recurring revenue and free cash flow ***per swipe*** and are not taking dangerous credit risk.

In late 2019, the Federal Reserve Bank of Atlanta released the results from its consumer payment choice survey. It found that debit cards were the most preferred payment method in the US, representing 28% of total transactions, followed by cash at 26% and credit cards at 23%. These three payment methods collectively accounted for over 77% of total transactions. Interestingly, "electronic payments", which includes online bill payment and bank account payments only accounted for 6% of total consumer purchases. As this chart shows, cash usage has declined from 31% in 2016 down to 26% in 2018. It is just a slow and steady decline. When Visa or Mastercard are asked who their competition is, they often just say "cash".

Share of Payment Instrument Usage by Year



Source: FRBSF, Compass Point. Note: The 2019 Diary of Consumer Payment Choice (Diary) highlights findings from the fifth Diary study conducted by the Federal Reserve. A demographically-representative sample of 2,873 individuals participated in the study and reported all of their payments and transactions over three consecutive days, staggered throughout October 2018.

Another survey, this one by The Harris Poll, found that 73% of US adults say they are much more likely to use digital payments or digital banking services during this period of social distancing. We thought this would be a good place to begin a dialogue on cash usage and how it might change in a pandemic like the coronavirus.

Mastercard estimates that over 80% of the world's purchase transactions are still conducted with paper currency and metal coins. We don't know about you, but we are using less and less cash each year. However, we are still in the minority. Cash usage varies between countries, as some are clearly more financially sophisticated (South Korea, Sweden, Singapore, US, etc). However, there are dozens are countries like Japan, India and Greece (just to name a few) that are still predominantly cash-based societies.

The End of Cash?

While we believe that cash will continue to be around for decades to come, we believe it is slowly and gradually declining towards insignificance. Cash is fighting an uphill battle to remain a payment option, especially during

this pandemic. Over the past month, the WHO or World Health Organization has advised consumers to avoid handling bank notes and is recommending people switch to contactless payments, to deter the spread of the deadly coronavirus. This advice comes after both China and South Korea began isolating and disinfecting used bank notes. In March, South Korea's central bank quarantined all bank notes (click here for article) and burned some currency to reduce the risk of outbreak. As an extra precaution, South Korea's bank also plans to literally "launder its money", through a high-heat process, before it goes back into circulation. While the US has not taken such proactive steps, the government does encourage all citizens to wash one's hands thoroughly after touching cash.

Quite simply, paper currency is a known carrier of viruses and bacteria. A 2017 study of used bank notes in New York found 397 distinct bacterial species sitting on our paper bills. A WHO press release recently stated "We know that money changes hands frequently and can pick up all sorts of bacteria and viruses. It advises people to wash their hands after handling banknotes, and avoid touching their face. Look at our second to last page for an interesting feature on hand washing.

The Centers for Disease Control & Prevention issued guidance for commercial establishments to practice good hygiene and has advocated and promoting "tap & pay" contactless payments. It stated, "it would be advisable to use contactless payments to reduce the risk of further transmission." Here are a few quick examples. A number of toll-highway authorities and bridge authorities have ceased accepting cash and coins and have closed their human patrolled toll-booths; This includes the Pennsylvania Turnpike, the Illinois Tollway, and the Central Florida Expressway Authority. All have ceased accepting cash, at least for the time being. Most are switching to a license plate based collection systems or the use of E-Z Pass like systems, leveraging cards as the primary funding source. Will this temporary no-cash policy last in the future? Will the avoidance of cash from the coronavirus actually spur electronic based payments? We think so…

Chicken Sandwiches:

Want more proof of COVID-19 changing the landscape for cash payments at the POS (point of sale). One of our absolute favorites is Chick-fil-A. C'mon! You can admit it. Is there really a better chicken sandwich than Chick-fil-A?

Following medical reports that show that currency and paper bills can carry and retain the virus, Chick-fil-A is beginning to go "cashless". Various Chick-fil-A locations in Florida, Indiana, Georgia, Virginia and Maryland are shifting toward a cashless payment model. While some stores are simply encouraging the use of mobile or credit card payment, other stores are restricting the use of cash altogether. A store in Severna Park, Maryland posted that it would "no longer be able to accommodate cash customers." Another Virginia Chick-fil-A posted on its website that it was officially going cashless. Fast food employees are already working under difficult conditions, so removing one risk seems like a simple and easy safety measure to take. So now consumers can't use currency to buy that delicious spicy chicken sandwich and we know they cannot get one on Sunday either.

Some cities (example: Philadelphia, San Francisco, etc) prevented locations from going "cashless" last year, as they felt it discriminated against consumers without mobile phones or access to credit or debit cards. We expect other merchants to follow Chick-fil-A and begin to encourage their customers to use either contactless payments, mobile payment or even their personalized mobile apps. Once a customer gets comfortable using a restaurant's mobile app, we believe it can be married with a loyalty program to increase usage, traffic and adoption.

Transportation:

Want another example or two? Last year, the MTA (Metropolitan Transportation Authority) launched a program on New York City's 4-5-6 subway lines. This program allowed riders to go through the turnstile by either using contactless payments or mobile based payments.

Dan Sanford is Visa's head of contactless payments and he said, "the adoption by New Yorkers first and foremost has just blown away expectations." The MTA reported that it handled its first million taps inside of the initial three month rollout and then it did another million taps in only three weeks. It was the most successful new initiative the MTA has ever launched. Adoption was so far ahead of any projections that the MTA added the service into buses, Penn Station and 85 other subway stations. By the end of 2021, the MTA expects to launch the functionality in all 472 stations.

NYC's Department of Transportation just expanded its efforts to discourage cash payments at its 14,000 parking meters. Through your smartphone with either the ParkMobile or ParkNYC apps, drivers will be able to pay for parking spots at New York City's 80,000 parking spots. ParkNYC handled 22 million parking transactions last year, while ParkMobile is available across the country and easily manages payments via Visa, Mastercard and American Express. A great feature in these apps notifies you when your parking is set to expire and allows the consumer to add minutes or hours to their parking reservation. This certainly beats running out to the car to add another quarter or two to the meter.

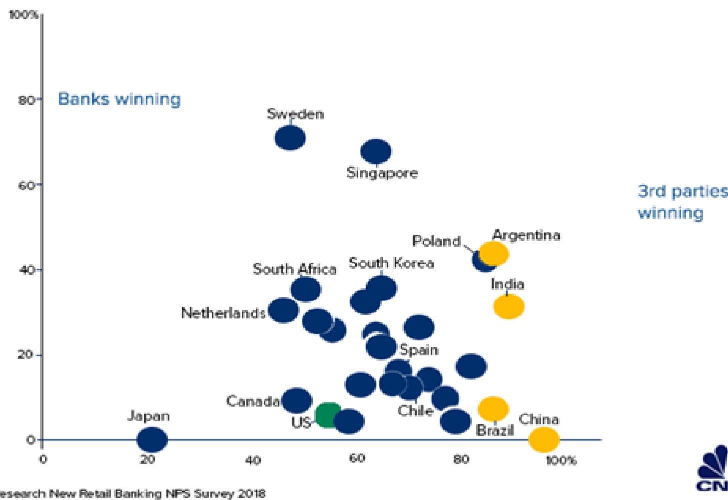
Mobile payments:

Mobile payments only account for a mere 2% of US general-purpose card payments. Many merchants fail to see the value that paying with our iPhones brings versus traditional magnetic stripe or card payments. Also, merchants are hesitant to invest in new POS (point of sale) technology, after their costly upgrade to accepting EMV or chip-based card payments.

However, the coronavirus might force a change in behavior for consumers around the world. Will you feel comfortable handing your card over to a waiter at a restaurant next month? Do you want to punch in your telephone number to get a $10 loyalty credit at the pharmacy? Do you want to use that plastic pen to sign your name onto that pin pad? We believe concerns over exposure to the virus, during a point of sale transaction, has the potential to drive significant interest in the use of contactless mobile wallets and contactless cards.

The WHO recommends using digital payments, such as mobile wallets to "bypass the need to touch card readers". It further states that contactless cards are a good option, as long as the POS device is compatible. According to a 2019 study from PULSE, 70% of issuers plan to offer contactless debit cards in 2020 and it expects 60% of the debit card market to be contactless by the end of 2021. This is noticeably higher forecast than Juniper Research's study from 2017 estimating that only 1/3rd of card payments would be contactless by 2022. If you would like to read more about how a contactless mobile payment occurs, via your iPhone, just click on our note from last year titled ***Does Apple Know Payments?***

Adoption:



As this Bain Research dot-chart shows, China and India are both very high on 3rd party payment solution adoption. Both countries historically were cash-based economies, but that has rapidly changed over the last 5 years. China and India are probably the best two examples where consumers have truly begun to embrace mobile payments.

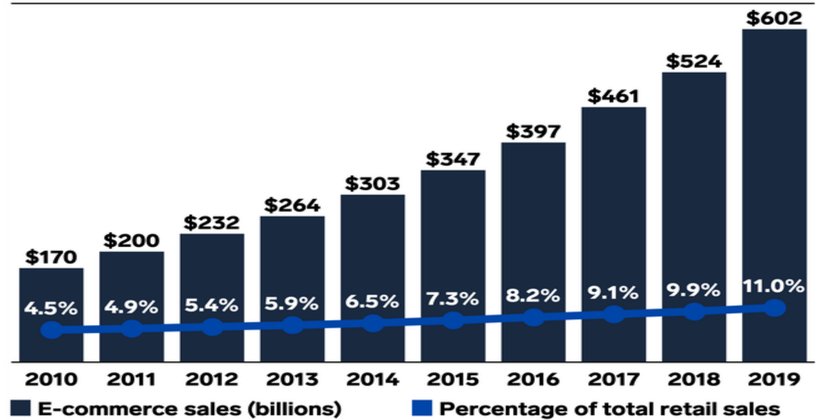
In our opinion, mobile payments are simply a better way to transact, as opposed to managing and keeping cash. However, let's use the 1.43 billion people in China and the 1.38 billion people in India as our evidence.

In India, regulators have been pushing to abandon cash and go digital. This migration away from physical bills was encouraged and supported by the government to increase its tax revenue. With the government eliminating certain low-end denominations, it spurred consumers to act. Also, several Indian FINTECH companies launched programs to capitalize on the digital opportunity and added low-value bank-to-bank transfer capabilities. The result was that mobile payments in India took off.

China's mobile-payment renaissance was not because of government intervention, but rather through technology enhancements. Tech leaders Alibaba and Tencent launched mobile payments and aggressively battled for customers wallets. During this process, both firms kept the mindset of helping both the merchant and the consumer transact. By focusing on the benefit of their customers, mobile payments exploded higher, at the expense of the traditional banking channel. Essentially, both have replaced the traditional funding source, like bank lines of credit (i.e. credit cards). Chinese banks will respond, but we'll leave that for another note. We'll discuss the Chinese bank response, when Visa and MasterCard are finally allowed to enter the market in 2021.

eCommerce:

In our view, shifting consumer spending patterns are likely to better insulate eCommerce players (PayPal's Braintree, ADYEN and Stripe) versus other more traditional payments peers. Over the last two decades, it is obvious that eCommerce has taken material market share from physical locations. Back in 2000, eCommerce represented less than 1% of total US retail sales. Now, as this chart shows, eCommerce has eclipsed 11% and it is steadily climbing higher.



With widespread shelter-in place edicts, shopping online has never been more prevalent. According to a recent eCommerce report from Adobe Analytics, online shopping in March for the US and the UK increased +25% and +33% respectively. Overall spending trends are clearly down and certain categories are doing much better (grocery) than others (consumer discretionary). However, in our opinion, the long-term growth of eCommerce will continue to grow.

Whether due to COVID-19 or not, we believe that consumer spending patterns continue to point towards secular and predictable growth of eCommerce. A few years ago, Evercore ISI did a survey inquiring about US consumers and their online grocery purchases. It found that in 2018, online grocery purchasers were at 16%. Then, it grew to 22% last year and was expected to hit 30% in 2020. This forecast was before the global pandemic hit, which has seen a dramatic shift online. We won't be surprised if online grocery shopping continues to flourish going forward.

The surge in grocery same-store sales in March was impressive, with Kroger up +30% and Wal-Mart up +20%. According to Nielsen, year-over-year sales of baking yeast are up +410%, powered milk +155%, pasta +104%, and frozen pizza +84%. However, consumer stockpiling food won't last forever. Our bigger point is that merchants must adapt and be able to sell the products both in their physical stores, as well as online. While our payment names are not immune to this crisis (as the number of transactions has declined), we expect their results will be "just fine". Those will more eCommerce exposure will especially stand out. Speaking of revenue growth, let's quickly discuss Stripe.

Stripe:

One of largest positions in the Manole Fintech Fund is a San Francisco-based, private FINTECH company named Stripe. In April, Stripe raised additional money and now has $2 billion of cash on its balance sheet, as well as an impressive $36 billion valuation. In their press release, Stripe said this war chest of cash is slated to go towards "product development, global expansion and strategic initiatives."

What exactly do we think Stripe is going after? Well, the COVID-19 pandemic is creating an opportunity that Stripe is ready, willing and able to capitalize upon. COVID-19 is clearly pushing the economy online; Stripe stated that it has seen "several years of offline-to-online migration compressed into several weeks." This just underscores the importance of merchants being able to transact in both the physical and online worlds. This eCommerce migration is captured in Stripe's mission, which is to "increase the GDP of the Internet".

As a private company, Stripe is not obligated to provide details of their current business or prospects. While it did comment that "the rate of new businesses going live on Stripe has accelerated since the start of the year," Stripe did release that one of its newest clients is Zoom, the developer of the popular video conferencing app.

Embracing Change:

Where do we see significant change occurring? We see change in the eCommerce payment processing space and with the advent of PF's or payment facilitators. As eCommerce transaction volumes continue to accelerate, there is a huge opportunity for many of our payment and software companies. Historically, payments and software firms were separated, but this has changed. The payment ecosystem was broken down into separate and distinct parties, each handling a specific aspect of a transaction. We laid out the case for these integrated payment solutions (IPSs) or integrated software vendors (ISVs) in our note from August 2017 titled "How GPN Changed the Merchant Acquiring Landscape." If you don't have the time to read that 4-page note, the takeaway was simple. Payment firms maintained control over the payment experience, but wrapped in software and value-added applications to become an essential component of running a business. By integrating software into the payment process, churn dramatically fell and these companies were able to show impressive revenue growth.

Now, this model is changing again. This time, PF's are employing specific practices to enable Mastercard and Visa transactions into their own proprietary software. Examples of companies we own that are capitalizing on this trend are Square, PayPal, and Stripe. Each enables customers to accept card payments without establishing a traditional merchant acquiring relationship. These entities can handle payment services for merchants that utilize their custom software, after completing a simple registration process. The key difference is that the software provider can also act as merchant acquirer, adding an unlimited number of "sub merchants" under its own account.

The payment space is evolving and the successful firms are those that embrace change, as opposed to running from it. Companies are facing difficult challenges today, but the migration away from cash shouldn't be one of them. Change is never easy and it is always more comfortable to keep the status quo. Some will fight

automation, while others will embrace change and adapt. Now, with a push from this virus crisis, it might be easier to enact some important changes. Waiting to do something because you are forced into action is rarely a positive approach to leadership. Abrupt shifts against one's will tend to be inefficient and threatening. We are always looking for our management teams to make these difficult choices, when presenting with a challenge. We have found that those companies that take the lead, because you can, not because you have to, are usually successful. Due to COVID-19, we expect an acceleration of contactless and mobile payments in the future.

Stress Tests:

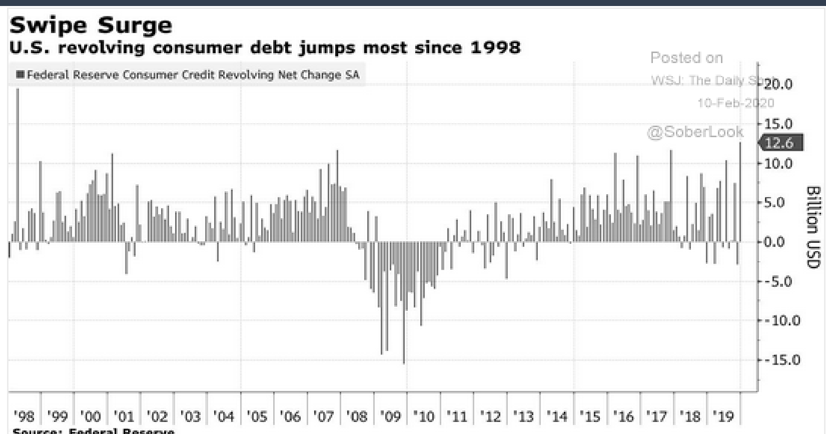
For the last decade, the Fed has asked banks to analyze the potential impact from a hypothetical recession. These tests were mandated in Dodd-Frank legislation and were enacted to ensure the US banking industry could handle any future decline. These stress tests asked for estimated bank results if the stock market plunged, oil dramatically fell, loan defaults rose and unemployment skyrocketed. Sound familiar?

Today, banks are currently dealing with the biggest crisis in a decade and are currently managing through the stress, as well as can be expected. JP Morgan's CEO Jamie Dimon recently said, when asked about today's environment, that "there are no models that have ever done this." In JP Morgan's "most adverse scenario" for how the coronavirus plays out, it estimates that credit costs could reach $45 billion this year. For perspective, this compares to the $47 billion it recorded in 2008 during the Financial Crisis. Does this scenario really reflect the worst environment or does it reflect a v-shaped recovery? We aren't so sure that this scenario reflects an extended, major downturn across the entire economy.

During the Financial Crisis, US banks were forced to "take their medicine". Following their re-capitalization, US banks significantly outperformed their European peers. Banks can defer dividends and suspend buybacks, but there is no substitute for having a fortress-like balance sheet. Just last week, Credit Suisse reported first quarter results and set aside only $584 million for future credit losses. This equates to 0.2% of its overall loan book and about 1/5th of several of its US banking peers. We worry that European banks, falling under less restrictive accounting rules, are once again failing to adequately account for potential losses. In our opinion, using the 2008 Financial Crisis as a guide, it would be smart to be more conservative and less optimistic about future loan losses.

Hot Potato?

As this chart shows, the amount of revolving US consumer debt has grown to epic propositions. As this revolving debt skyrocketed, the amount consumers were not paying back was modest. If the vast majority of consumers are gainfully employed, they will most likely payback what they owe on their credit cards or at least the minimum amount due. However, when the environment changes, as it has with COVID-19, so too does that pesky delinquency and default rate.

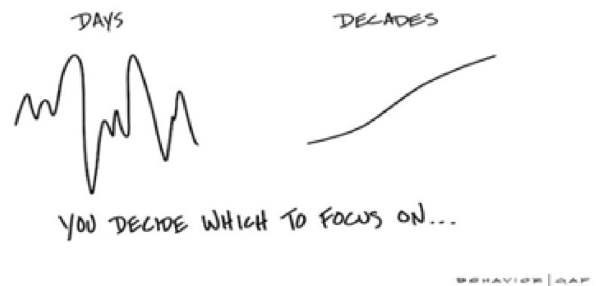


Many US consumers were already deep in debt before the virus, with record highs in credit card, auto loans and student debts. JP Morgan just reported results and revenue fell by (3%), but earnings declined by (69%). Wells Fargo reported a (18%) decline in revenue and year-over-year earnings fell by (89%). Bank of America saw its earnings fall by (45%) and Citigroup's earnings fell (46%). The largest hit to earnings for all these banks is how much it decided to hold back for an expected wave of loan defaults. Citi set aside an additional $3.6 billion for potential bad loans. JP Morgan chipped in $6.8 billion for future bad loans, while Wells Fargo lifted its provision by $3.8 billion. Even American Express, with its higher end customers, more than tripled its credit loss estimate. Only time will tell if these provisions will be enough.

JP Morgan's CFO is Jennifer Piepszak and she said on the 1st quarter earnings call that the "outlook is uncertain" and that "more provisions are highly possible" in the future. Citi's CEO is Michael Corbat and he said that "looking forward, there are too many unknowns to count." Only time will tell if all of our banks are strong enough to survive, but it probably wasn't an ideal time for our regulators to be pushing through new accounting rules governing allowances for loan losses.

Conclusion:

We recently saw this picture and we liked how it brought our attention back to the long-term. During any dilemma, one easily can get consumed by short-term thinking and the most recent news cycle. At Manole Capital, we are long-term investors, taking a long-term perspective. We strive to anticipate, as opposed to react. Of course, this is easier said than done…



Peter Drucker (1909-2005) was a legendary author, educator and thought leader of the study of management. One of our favorite quotes of his is, "the only thing we know about the future is that it will be different."
We know the next few months will likely be challenging, but we are confident that we will embrace our differences, adapt to new conditions and find a way to succeed.

The market is starting to get attractive, but we are remaining patient and disciplined. In today's market, all stocks are being treated similarly. Once we emerge from this virus, all companies will not be on equal footing. We have our shopping list, and we are selectively buying.

With the help of caring and thoughtful neighbors and friends, we will find our way through this crisis. All best to you and your colleagues, friends, and families during this challenging and unsettling time.

I look forward to speaking with you soon!

A FINTECH Guy's Medical Wisdom:

This pandemic is testing the world's medical systems and its ability to mount a coordinated response. Do we have enough testing equipment? Enough beds in hospitals or ventilators? Even in 2020, the medical profession is arguing that the best defense against COVID-19 is simply washing your hands. Apparently, nothing kills germs better than a good 20 or 30 second vigorous hand washing with soap. While washing our hands might seem like fairly basic hygiene, it wasn't always that way.

The first doctor to truly understand the importance of hygiene, in stopping the spread of infectious diseases, was a Hungarian physician named Ignaz Semmelweis. While working in the maternity department of Vienna's General Hospital in the 1940's, Dr Semmelweis had the "crazy" idea that dirty conditions in the hospital were playing a role in spreading infections. Dr Semmelweis was unable to convince his colleagues that fevers and infections were spreading in the hospital due to contaminates easily prevented with simple hand washing.

How popular was Dr Semmelweis and his advocacy for washing one's hands? Well, apparently his colleagues and "friends" lured him in July of 1865 to visit a new medical facility. Little did he know that this medical institute was a Viennese insane asylum, where Dr Semmelweis was beaten, straitjacketed and confirmed to a cell until his death two weeks later. Making this totally ironic, Dr Semmelweis died from a wound on his hand that had become gangrenous. While Dr Semmelweis's theories never received acceptance in his day, we would be wise to heed his advice today.

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