Manole
Capital Management

Payment Networks

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We are business buyers and investors, not short-term traders. Our focus is to do in-depth research on strong, durable franchises. We strive to buy great companies at reasonable prices. Our core belief is that value is driven by time, not timing. The process seeks to identify growth businesses with key attributes. Adhering to these investment traits leads to positive stock selection and outperformance.

The characteristics were look for are:

- ✓ Market leaders with durable competitive advantages
- ✓ High barriers to entry and "moat" around franchise
- ✓ Pricing power and flexibility to withstand market volatility
- ✓ Recurring revenues and sustainable business models
- ✓ Strong balance sheets with predictable free cash flow

Classifications:

When we mention these traits to investors, we often hear "of course"! Most investors look for these same desirable characteristics.

The S&P 500 can be segmented or broken down into 10 different sectors: Healthcare, Technology, Financials, Industrials, Consumer Discretionary, Staples, Energy, Utilities, Materials and Real Estate. We try to avoid these strict definitions and industry classifications. Instead, our investment philosophy looks for wonderful businesses and attractive valuations regardless of sector. It just so happens that many of the companies we identify during our process tend to be in the financial sector or in technology-based businesses.

What we look for in "Technology" companies:

Within technology, we tend to prefer companies with little risk of obsolescence. Once again, we are attracted to companies generating sustainable and recurring revenue. The secular growth of digital payments, for instance, should provide years, if not decades, of predictable growth.

Advice from Buffett:

Legendary investor Warren Buffett writes very readable and compelling annual letters to his Berkshire Hathaway's shareholders. In his 1991 annual report, Buffett had a great perspective on identifying the value of a franchise. He believes there are two kinds of enterprises. One is a business and the other is a franchise. If you have the right product,

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investors are comfortable paying for this positive mental association. He argues that most successful franchises have characteristics like: no close substitute, a product or service that is needed or desired, and not being subject to price regulation. Lastly, Buffett believes that a franchise can price its products aggressively and still earn high rates of return on capital. Once it is possible to identify franchise value, the real trick is to properly frame how resilient it is. Buffett describes a franchise like a "moat around your economic castle". How big is it and how durable is that franchise?

Example #1: Payment Networks:
Back in 2012, Visa and MasterCard were both under pressure from a new competitive threat. A consortium of 70 major brands and 40 big box retailers were joining forces to create the Merchant Customer Exchange or MCX. Companies like Wal-Mart, Target, Lowe's, CVS, Rite Aid, Shell, Mobil and others formed MCX to create a merchant owned mobile commerce network. MCX had a noble goal. It wanted to create a free app to let customers save time by centralizing loyalty, rewards, coupons and promotions at participating retailers checkout counters. The un-stated, but real goal was to lower their cost of accepting card transactions (called the Merchant Discount Rate or MDR in the payment industry). MCX was going to create the latest in must have payment apps. The app was called CurrenC after its original name – ISIS – became an obvious liability.

The Street was worried that these retailers were powerful enough, with their 110,000 locations, to end the dominant position of the two largest payment networks. In terms of market share dominance (according to The Nilson Report), Visa and MasterCard represent roughly 75% & 91% of all global credit & debit purchase transactions. The companies generate operating margins in the 50% to 60% range. This kind of profitability and market share dominance is always going to attract competition.

Keep it simple:
In our opinion, the beauty of these franchises is their simplicity. We are not saying it is simple to authorize, clear, process and settle global credit and debit cards transactions. In fact, it is a terribly complex transaction that often occurs in just a few seconds. The simplicity of their business model is that customers can transact easily and make payment however they wish to transact. MCX and their CurrentC app were attempting to force customers to make payment via the Automated Clearinghouse or ACH network. By using ACH and not traditional funding sources (ie: credit or debit cards), participating merchants would be able to lower their operating costs. Forcing customers to utilize a different payment methodology, rather than one they are already very comfortable using,

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was not smart.

Last month, MCX postponed and then shut down its rollout of its merchant controlled mobile wallet. However, no sooner did this happen then Wal-Mart announced the launch of its new payment app called Wal-Mart Pay.

A different type of competition:
Meanwhile, there was another potential payment threat in the works by 2014. Apple Pay was being launched with the new iPhone 6. Android Pay and Samsung Pay were also going to be released and many feared that these mobile wallets were going to threaten Visa and MasterCard's market dominance. The market assumed that Apple, with its beautifully designed phones and fully integrated operating system, would look to create and capture payment market share. It was common thinking that the world's largest company would use its ample resources to invest in a business that generates 50% to 60% operating margins.

As these new apps came to market, it was clear that these entities understood what their value add was to the consumer equation. None came out with an app that required some elaborate sign-up process or one that did not utilize traditional debit or credit cards. Instead, these phone and mobile operators recognized that Visa and MasterCard provide a valuable service, and have a wonderful franchise with a dominant and wide moat. These potential competitors decided it was a better choice to partner with rather than fight the established payment players.

Looking forward:
We do not know which mobile wallet will ultimately grow and become the latest must have app. One might have allegiance to the Apple iPhone, while others believe the Samsung phone is the latest and greatest device. We do not need to go too far back in history to remember how dominant Blackberries were in the hardware segment. It is our belief that providing customers with choice is a better alternative. All successful payment apps or newly created mobile wallets should allow bank issued credit and debit cards to act as a funding source. Behind the scenes, we expect both Visa and MasterCard to be the dominant payment networks executing these purchase transactions. This should provide years of future growth.

Growth:
The secular growth of digital payment networks will come from steady conversion from cash and check to card-based payments, and higher penetration of online purchase

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transactions, which need to occur electronically. In addition, there are emerging markets that are slowly embracing digital payments. For example, China is estimated to be an $8.4 trillion dollar market opportunity. The Chinese market should continue to grow in the double-digit range and it currently represents over half of the 9.5 billion cards issued globally.

However, despite its large card-issued market share, China Union Pay (or CUP) only represents roughly 10% of global purchase transactions. The card market in China is protected by the Peoples Bank of China, which limits the ability of foreign competitors to enter. Over the next one to two years, we believe these official rules will be opened up for players like Visa and MasterCard to begin to capture some of this growing market. Visa is partnering with China Union Pay and MasterCard has relationships with Alibaba and Tenpay. It is this type of open-ended growth and opportunity that leads great franchises to garner a high weighting in our portfolios.

Conclusion:

Once again, this growth will be predictable, sustainable and recurring in nature. That is our definition of a formidable franchise with significant competitive advantages. These two companies clearly meet all of the characteristics we mentioned earlier.