MANOLE CAPITAL MANAGEMENT

Global Payments (ticker GPN)

June 2022

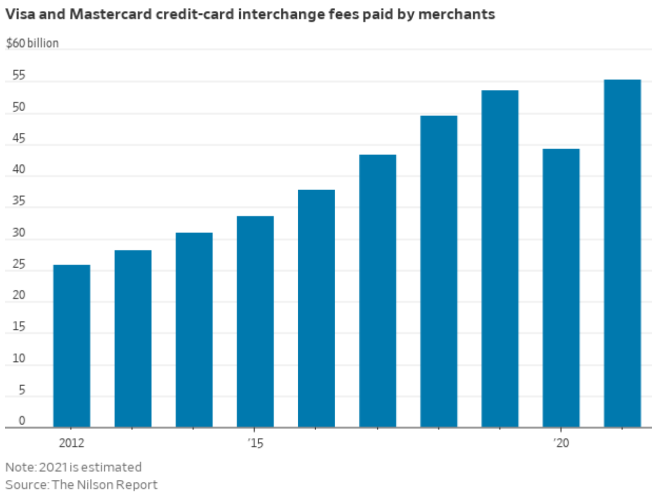
Introduction:

The world is dealing with multiple geopolitical risks, soaring commodity costs, sky-high inflation, all while the Fed is pushing through a round of monetary tightening policies. A year ago, the S&P 500 rose +28% and the market was anticipating a "return to normal", following a couple of years of a global pandemic. Instead, uncertainty grips the market, as Ukraine defends itself against a hostile Russia and energy costs climb. All of these macroeconomic headwinds are worrying the stock market and posing a series of systemic challenges.

In times like today, fundamental analysis can be profitable, if one can "uncover a hidden gem". During this uncertainty, we believe that Global Payments (ticker GPN) is one such *"Diamond in the Rough".* We will discuss their business, industry trends, what is driving their growth, and GPN's compelling valuation.

Understanding Payment Economics:

The total cost for a merchant to accept a card transaction is called a MDR (merchant discount rate), while interchange represents the fee the card-issuing bank earns for providing consumers this monthly line of credit.



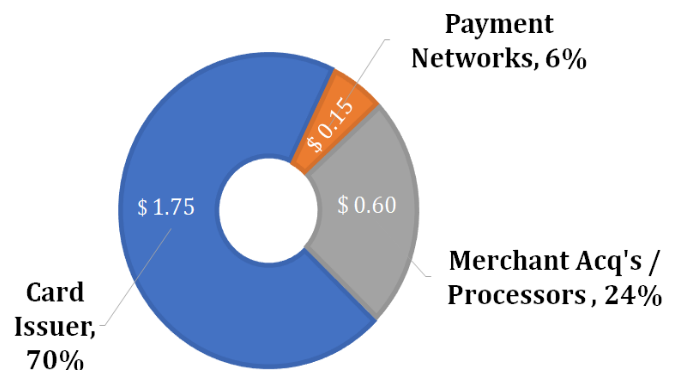
This is a chart showing just the interchange that Visa (ticker V) and Mastercard (ticker MA) charge to merchants for enabling credit cards. They do not receive these fees but pass them onto to other players in the payment food chain (to the card issuing bank).

Over the last decade, there are few companies that can show such a steady climb in underlying strength. Obviously, the 2020 results were impacted by COVID, but we anticipate the growth to expand for years into the future.

Despite price affecting their bottom lines, most small to mid-sized businesses are not terribly focused on their costs of card acceptance. Many think it is the cost of doing business, no different than the cost of electricity, rent or insurance.

Accepting cards is expected by consumers, and most merchants simply want the process to occur seamlessly and fast. In the event of a problem with a piece of hardware or PoS (point-of-sale) device, merchants want their acquirer to quickly fix the problem and keep the check-out process running. Monthly statements can be complicated and crowded with unidentifiable fees and charges. If business is good, the merchant can afford to ignore the costs. If business is soft, the business owner will likely shop competing acquirers, changing for a lower price.

In a typical $100 US credit card transaction, roughly $2.50 in fees will get distributed to various payment participants. We created this pie chart to show which entities get paid on a simple $100 credit card transaction. Now, this is just an estimate, as the merchant type would ultimately determine the fees charged, but it is a decent proxy for the divvying up of the $2.50 in merchant costs.



As you can see, the vast majority of the payment economics goes to the card issuer, for providing a line of credit to the consumer. Card issuers take the risk and therefore should

earn the majority of the economics, in the form of interchange (see chart on prior page). The card issuer earns 70% of the $2.50 or $1.75 in fees. With that revenue, they have to offset significant marketing costs (i.e., miles, points, rewards, ads, etc.), losses, and delinquencies.

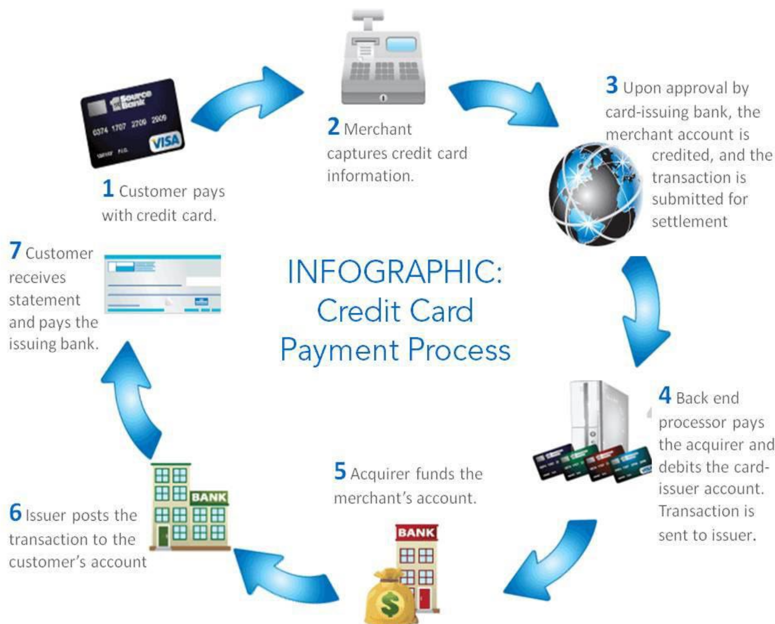
Acquirers and processors earn the next highest amount of income, as they do the "heavy lifting" of a transaction. For authorizing, clearing, and settling a transaction, these payment companies earn healthy economics (24% of the $2.50 in fees or $0.60). These companies benefit through scale economics and are able to generate impressive FCF and operating margins.

Lastly, the networks earn the smallest amount of money, just 6% of the $2.50 in fees or $0.15. The payment networks are the "rails" that a transaction runs across. For building powerful brands, with global payment acceptance, the networks earn recurring revenue and unbelievable margins. While they earn the smallest amount on each card transaction, the networks earn predictable fees on billions of transactions covering trillions of dollars of purchases. For example, V posted operating margins in the 1st quarter of 2022 of 67%. Can you name any company that boasts operating margins this sustainably high? If you do, please let us know; we'd love to quickly become shareholders.

Merchant Acquiring vs Payment Processing:

Most consumers expect card transactions to occur in a matter of seconds. Whether using traditional plastic, with its 60-year-old magnetic stripe, or mobile-based payments, like Apple Pay, the process for merchants to accept card payments is fairly straightforward.

With the adoption of EMV (Europay, MasterCard, Visa) standards, chip-embedded transactions slowed down the process by a couple of seconds, but increased security and lowered counterfeiting. New technology has not dramatically impacted consumer preference but has affected merchant technology needs.



This diagram covers the steps involved in a credit card process. Merchants are allowed to accept cards by creating and relying on a relationship with a merchant acquirer.

The payment processor handles the authorization, clearing and settlement of a transaction, but it is a complex process between four distinct market participants (acquirers, processors, payment networks and card-issuing banks).

There are hundreds of companies that can acquire a transaction, but there is only a dozen or so of firms that can handle the "heavy lifting" of completing a card transaction in seconds. On the merchant acquiring side of the business, most investors have heard of companies like Square (ticker SQ), now called Block. Many acquirers simply outsource the processing to scale providers.

On the payment processing side of the business, few have even heard of companies like Fiserv (ticker FISV) that acquired First Data in 2019, or FIS (ticker FIS), that acquired Vantiv / World Pay in 2019. Most have never heard of other a company like GPN, as it does not need to spend money on building a well-known and costly brand. Later on in this research note, we will focus on GPN, who is a top 10 global payment processor.

Merchant Acceptance:

For decades, teams of salespeople targeted various merchants trying to entice them into allowing them to handle their card processing. On average, US merchants will pay 2.2% to accept a credit card and roughly 0.7% to accept a debit card.

Payment networks like Visa and MasterCard publicly post their Interchange rates, but these forms are difficult to decipher. Visa's rate card is very complicated and what we are showing is essentially just 1 of 20 total pages.

In addition to network charges and interchange, the merchant has to pay for the acquiring and processing of card acceptance. The "devil is in the details", as this Visa interchange fee schedule shows. The rate card for card acceptance is varies depending upon multiple factors. What is the merchant processing method? Is the card present in the physical location, or is it a CNP (card not present) transaction? What kind of transaction data is provided? Is the expiration date, zip code or a security code captured? What is the MCC (merchant category code)? This data helps frame the potential for fraud and chargebacks.

C Visa U.S.A. Consumer Credit Interchange Reimbursement Fees

Rates Effective April 13, 2019

Fee Program	Visa Signature Preferred / Visa Infinite†	Visa Signature / Visa Infinite*	Traditional Rewards	All Other Products
CPS/Supermarket Credit—Performance Threshold* I	2.10% + $0.10	CPS/Rewards 1 1.65% + $0.10	1.15% + $0.05	
CPS/Supermarket Credit—Performance Threshold* II			1.20% + $0.05	
CPS/Supermarket Credit—Performance Threshold* III			1.22% + $0.05	
CPS/Supermarket Credit—All Other		CPS/Rewards 1 1.65% + $0.10		1.22% + $0.05
CPS/Retail Credit-Performance Threshold* I		CPS/Rewards 1 1.65% + $0.10	1.43% + $0.10	
CPS/Retail Credit-Performance Threshold* II			1.47% + $0.10	
CPS/Retail Credit-Performance Threshold* III			1.51% + $0.10	
CPS/Retail—All Other		CPS/Rewards 1 1.65% + $0.10		1.51% + $0.10
CPS/Small Ticket		1.65% + $0.04		
CPS/Retail 2	2.40% + $0.10	1.43% + $0.05		

There are good businesses and there are great businesses. We would argue that both Visa and Mastercard are examples of fantastic business models, with high barriers to entry, large moats around their franchises, wonderful margins, and prolific free cash flow.

Building a Brand:

The market and most investors know these payment companies and they aren't "hidden gems". When one begins to understand the payment process and dives into some of the nitty-gritty details, a name like GPN can be "uncovered" as a "hidden gem".

Visa and Mastercard are accepted in over 200 countries and that little "bug" on the bottom right of each plastic card enables transactions to occur in seconds. Their brands stand for payment acceptance, permitting billions of transactions to seamlessly occur every year. As we just discussed, for promoting worldwide acceptance, both networks earn a sliver of the fees from a payment transaction. To market itself as the easiest way to pay, both networks have spent billions of dollars in marketing and branding. For example, Visa currently sponsors the Olympics (through 2032), the 2022 Qatar World Cup and the NFL (since 1995). Both companies have spent huge sums of money, simply building brand awareness and global card acceptance.

These "investments" benefit not just the networks, but also the entire payment ecosystem. V and MA are the opposite of a "*Diamond in the Rough*", as they are both polished gems. A company like Global Payments gets to ride on the network's coattails, as it benefits from card usage without having to spend enormous capital on marketing, brand building or expensive TV ads. Now, let's dive into the fundamentals and details of GPN.

Changing the Payment Model:

In August of 2017, we wrote a quick 5-page note on GPN. We published it and it is still available to read on our website at www.manolecapital.com/research. That note specifically addressed how GPN changed the merchant acquiring and payment processing landscape (five years earlier), with its acquisition of APT in August 2012.

Fast forward a decade to 2022 and the entire payment industry has moved away from discounting prices on MDR's (merchant discount rates) towards software companies called ISV's (independent software vendors). GPN's goal with its APT acquisition was not to simply permit its clients to accept credit and debit cards. Even more enticing than simple payment processing, GPN was trying to become an integral component of their client's business. Instead of competing with peers that are constantly cutting pricing to win market share, ISV's are fully-integrated into their merchants and cannot be easily be replaced. Why just handle credit and debit processing, when you can also do payroll, inventory, website development, cloud storage, financial reporting, CRM, and dozens of other valuable business functions?

Instead, it was trying to get embedded into their client's workflow. Software gets developed and customized to fit one specific vertical, but it then can branch out and migrate to other industries. For example, GPN's APT acquisition was initially a software provider allowing dentists to efficiently manage their practices. Now, GPN has taken this software across other medical verticals, including pharmaceutical and veterinarians.

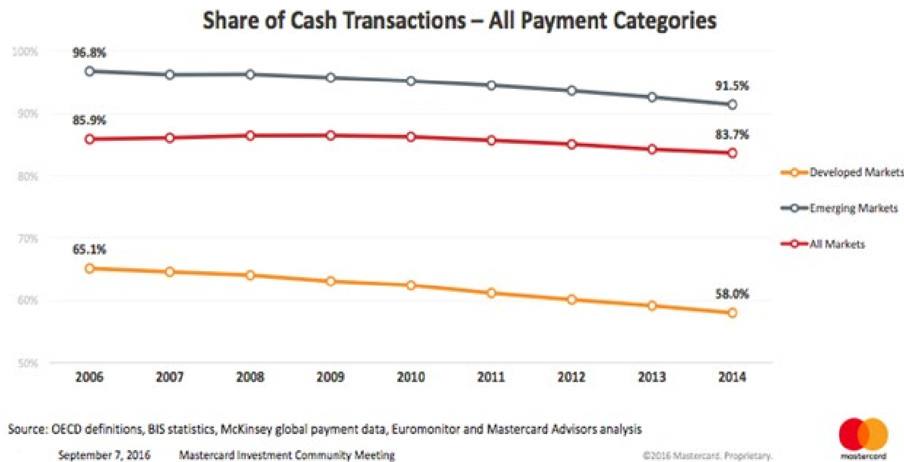
The key takeaway is that GPN has brought a highly flexible platform to its customers, enabling these companies to effectively manage their entire business. Through an elaborate network of VAR's (value-added resellers), technology is being sold into all types of businesses. Instead of simply competing in a price war, card acquirers are using technology to provide a better product. Software capabilities and integrated hardware devices are morphing this hyper-competitive industry into a technology battle. In years past, the barriers to entry were small. An acquirer could knock on the door of a merchant, lower price and win business. Now, technology and integration make this price battle nearly irrelevant.

Also important, but not as clear to many in the market, was the retention factor. If GPN became ingrained into these merchants, it would no longer be at risk of losing clients to competitors. In fact, GPN changed the entire argument. By becoming an integral component in how business is run, GPN made the price it charges a merchant for accepting cards almost irrelevant. Merchants were no longer tempted to switch acquirers based upon cost, as GPN is too vital in running their business.

GPN's acquisition of APT is about to have its 10-year anniversary, but few will celebrate how this deal significantly changed the merchant acquiring landscape. GPN started a trend, essentially a technology arms race back in 2012. A decade ago, businesses still shifted away from incumbent acquirers for a new POS device and a discount of few basis points off of their MDR. Now, ISV's use advanced software to become embedded into their client's critical workflow. Times have definitely changed…

Secular Growth:

What hasn't changed is the steady and secular decline of cash usage. We know that you are using less cash today than you ever have. How do we know that, since we don't even know who is reading this note? Well, it comes down to convenience and a pull-forward of digital payments following COVID.



As this older Mastercard slide shows, the use of cash has been in decline for years. Globally, back in 2014, cash still accounted for a low 80's percent of total purchase transactions. It is now estimated that cash still accounts for a mid-70% of purchase transactions. While it has declined from the low 90's a decade ago, cash usage continues to fall.

Surprisingly, paper checks still account for 6.5% of US purchase transactions. We highly doubt this slow and steady decline of cash and paper checks will reverse itself anytime soon.

Certain developed countries (i.e., the Nordics, US, etc.) are migrating towards digital payments and away from cash at a faster pace. According to Ida Wolden Bache, deputy governor of Norway's Norges Bank, she says that "only 4% of payments are now made using cash. To our knowledge, the share of cash payments is lower in Norway than in any other country." China has rapidly adopted mobile payments, with over 80% of consumers adopting Alipay. Here in the US, Apple Pay still only garners less than 10% adoption, but it is growing nicely. While certain countries have embraced digital payments, there are other developed countries that are still slow to shift. For example, developed and mature countries like Japan and Germany are both over 80% cash-based, primarily still transacting in paper currency.

Now that we are 2 years removed from the initial COVID worry, there are multiple payment takeaways to identify. Merchants are focused on providing consumers a touchless experience at the checkout counter, which has boosted contactless payments. Looking at stats from the Federal Reserve 2021 Payments Study, contactless card payments soared +172% in 2020, reaching 3.7 billion transactions. Despite a shortage of microchips, global shipments of contactless cards hit an all-time high of 2.63 billion in 2021 (according to the Smart Payment Association). Now, contactless cards account for 76% of global payment card shipments versus 59% in 2019. In our opinion, contactless cards will dominate the payment landscape in the future.

Fintech-company Marqeta just surveyed 4,000 consumers across three continents in their annual State of Consumer Money Movement research. Not surprising, it found that digital usage is on the rise. According to its findings, 61% of consumers are confident enough in contactless payments to leave their wallet at home. This percentage rises to 77%, when asking UK Gen-Z respondents. Take a look at our proprietary Gen-Z surveys (click here) for evidence that this shift has already begun.

Even with this spectacular growth, contactless payments still only accounts for 4.63% of all in-person card payments (up from 0.77% of 2018's card payments). While the rollout of NFC (near field communication) enabled cards has been steady, most consumers don't realize that they can simply tap their cards to the POS reader to transact. Many prefer to swipe (using 1950's magnetic stripe technology) or dip their chip into the card reader. Some merchants have embraced QR codes, like the wildly popular Starbuck's app. The disappearance of cash and checks continues to create a strong, secular tailwind for all participants. Whatever digital forms of payment succeeds it will steal market share from cash; it is just a matter of time. It won't happen overnight, but younger generations are happy to shift away from bulky leather wallets towards transacting with their iPhone.

Wallets:

We personally don't believe that physical cards are the future. We believe digital devices (i.e., your iPhone or iWatch), with embedded cards or payment permissions, will be how we transact in the future. Whether it is in a physical store or online, we believe credit, secure lines of approved payment (BNPL or buy now, pay later) or even debit will thrive across personal devices. Not your bulky leather wallet.

Tokenized card credentials will become the defacto payment method, instead of 16-digit PANs, expiration dates and customer zip codes. It is more convenient (and safer) for consumers to utilize these newer payment methods, than traditional payment processes. However, it will take time for this technology to become widely embraced.

Eventually, consumer preferences will shift to the most convenient and secure form of payment, which will likely be their smartphones. Once transactions migrate to a smartphone, it becomes remarkably easy to load up multiple cards (credit, debit, pre-paid, store value, etc.). We believe that the biggest trend in payments (over the next 5 to 10 years) will be removing those unwieldly wallets from our pockets.

In our opinion, your smartphone will become the only thing you'll need to carry. It will have all of your credit and debit cards, your driver's license, as well as your hockey tickets (Go Bolts!). Here in the US, tap-to-pay has yet to truly get embraced, but it is coming. Convenient examples are payment acceptance at everyday restaurants, as well as on subways, buses, and trains. Once this becomes commonplace, we anticipate a cash digitization explosion.

The days of looking like Seinfeld's George Costanza are coming to an end…

ATM's:

In addition to contactless payments, one can just look at the falloff in global ATM usage and networks availability. As consumers adopt digital banking and payment services, there simply is less need or demand for cash and ATM machines.

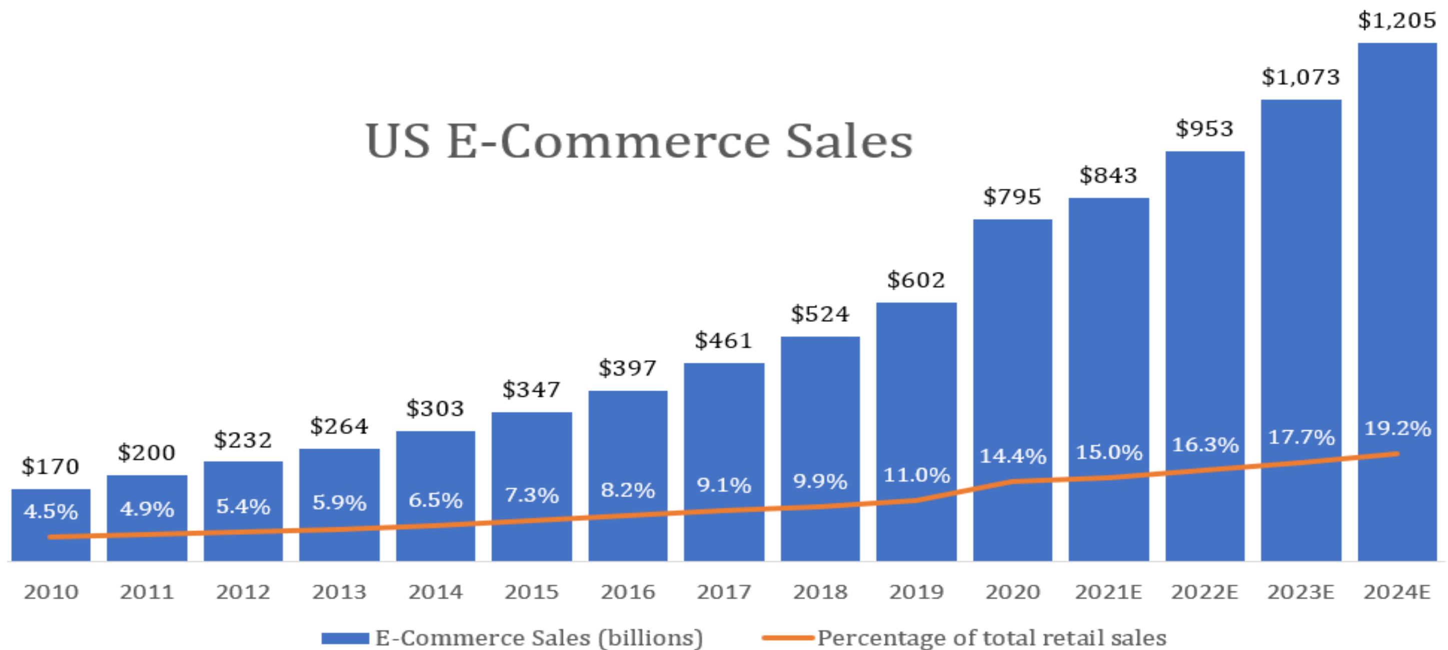
From 2015 to 2019, US ATM's rose 8% to 470,000 machines. Then, COVID struck, and the cash market materially shifted. YouGov estimated that ATM usage dropped by 60% during the pandemic. According to payment research firm RBR, the number of worldwide ATM's decreased by (2%) last year to 3.09 million, following a (2%) decline in 2020 and a (2.5%) decline in 2019. RBR also estimates that the universe of deployed ATM's will fall another (5%) by 2027. Banks are increasingly focusing on cutting costs and deciding to close down costly real estate branches and ATM's.
COVID only accelerated this trend. Because of the pandemic, more and more people became worried about touching "dirty" paper money. It didn't help that the CDC recommended that consumers immediately wash their hands thoroughly after touching paper currency. McKinsey estimates that the use of cash will annually decline by 6% through 2025, as more consumers choose to utilize digital wallets and embedded credit and debit cards.

In a couple of decades, we won't be surprised if ATMs become as rare as public payphones. Speaking of payphones…Did you see that New York City removed its last public payphones last week?

eCommerce:

Looking at this slide, we can see how eCommerce is the gift that continues to give to all payment participants. Going back to 2010, eCommerce only represented 4.5% of total retail US sales. Each and every year, this growth grew "up and to the right." By 2019, US eCommerce represented 11% of total retail sales and the expectation was that continued growth was predictable and steady.

However, COVID struck and actually accelerated the trend towards eCommerce transactions. With COVID lockdowns, eCommerce stole material market share from brick-and-mortar retail locations. Online transactions spiked higher, and these transactions have to be done with a card or digital payment platform (not cash). US Census Bureau data estimated that eCommerce grew to 14% of total retail sales, gaping higher by over 300 basis points.



Source: Historical Data US Consensus and Estimates from eMarketer, Oct 2020

According to Adobe's eCommerce research, from March 2020 to February 2021, US consumers spent $844 billion online. To put that into perspective, that is more than US consumers spent online in all of calendar year 2020 and it equates to an entire holiday shopping season (late November to mid-December).

Some physical retailers were crushed during the global pandemic and in-store transactions dropped by 11.7 billion (according to 2021 Federal Reserve data). Remote and eCommerce transactions increased by 8.7 billion transactions, to make up some of this lost consumer spending.

Merchants were forced to adapt, and many began to allow both in-store, as well as curbside pickup services. This BOPIS (buy online, pick-up in store) is a trend that seems to have the wind at its back. In order to accommodate this this checkout experience, merchants are required to have real-time inventory management systems capable of fulfilling those requests. This is just another example of how merchants can benefit from the integration of a customized software program versus a traditional platform. The overriding theme is that eCommerce isn't going away, and the trend will continue to grow – "up and to the right" for years to come.

Inflation:

For years, the Fed strived to get annual inflation up to 2%. Instead, inflation hardly budged. A year ago, the Fed believed that inflationary indicators were only "transitory", and it remained quite accommodating. In May, year-over-year CPI unfortunately rose to +8.6%, up from +8.3% a month ago. Core CPI was +6.0% which was the highest level of annual growth since December of 1981. Clearly, that wasn't the case, as inflation has now reached a 40-year high.

Former Fed Chairwoman and now Treasury Secretary Janet Yellen just admitted that she failed to fully appreciate the sharp rise in inflationary pressures. Last week, she said "I think I was wrong then (in late 2021) about the path that inflation would take." Yellen originally framed inflation as a "temporary side effect of the economy returning to normal following the pandemic", and blamed snags in supply chains for inflationary pressures.

So far this year, the Fed has raised interest rates by 75 basis points, but there is more work to do. The Fed's recently appointed Vice Chairwoman is Lael Brainard and she just hinted at two consecutive 50 basis point interest rate hikes, in June and July. On Wednesday, the 15th of June, the Fed will deliver its 2nd straight 50 basis point rate hike, as it seeks to control inflation. A day or so later, we will get easing monetary decisions from Britain and Sweden too. These will likely not surprise the market, as all have tried to indicate intentions to the broader market. The contrast remains the Bank of Japan, which remains steadfast in its ultra-dovish stance. It remains the only G-10 country with a dovish monetary policy, as it sticks with its constant stimulus plans.

Besides increasing its benchmark rate, the Fed has other tools at its disposal. For starters, it could signal (in its forward guidance) a much more aggressive posture towards inflation, in its testimony, speeches, and public commentary and statements. With commentary on its future plans, it can provide the market with hints; as everyone knows, the market doesn't appreciate surprise, shock, and awe. Analysts love to try to decipher the Fed's "dot plots", and what it means for expectations, but that's a game we prefer to leave to others. We prefer to look at the CME Marketwatch tool (click here), where we can see exactly what the Street is expecting. As of now, the Street is anticipating a 1.5% lift in Fed Funds over the next three FOMC meetings.

Brainard said "from the data we have in hand today, (higher rates) seems like a reasonable path". Then, she said "if we don't see the kind of deceleration in monthly inflation prints (by September), if we don't see some of that really hot demand starting to cool a little bit, then it might well be appropriate to have another meeting where we proceed at the same pace. Right now, it's very hard to see the case for a pause". Can the Fed be nimbler and tactical? Many say that this is environment is too challenging, like trying to water ski off of an aircraft carrier.

Speaking of the inflationary environment of the late 1970's and early 1980's, how great is this picture of former Fed Chairman Paul Volker. If there ever was a picture that perfectly shows the economic conditions during a period of time, it might be this.

Not only is the look on his face filled with annoyance for having to endure endless Congressional questioning, but he gave his testimony with a cheap and unlit cigar in his hand.

Just classic!

There's little doubt that inflation is permeating through our economy. If you drive a car, filling up your gas tank now well exceeds $100. Going out to dinner and a movie (even without a babysitter) will cost over $100 too. We are all struggling with higher costs, but the payment stocks offer an opportunity to benefit from inflation. Why? Well, payment companies earn their revenue off of the number of transactions, but also on the face value of those transactions. If the average credit card MDR is 2.2%, the payment revenue associated with each transaction goes up too, as the face value of the purchase goes higher.

Just look at this bar menu and its prices at last month's PGA Championship in Tulsa Oklahoma. Michelob Ultra for $18? That seems excessive, but I'm sure there were thousands of thirsty patrons purchasing that beer. I guess we can take some solace in the fact that it was a 24 ounce can, not a traditional 12 ounce can. I know…I'm splitting hairs on that one.

SELECTIONS
AT THE MASTERS

SANDWICHES		BEVERAGES	
Egg Salad	1.50	Masters Blend Fresh Brewed Coffee	2.00
Pimento Cheese	1.50	Fresh Brewed Iced Tea	2.00
Chicken Salad on Brioche	3.00	Sodas, Lemonade, Sports Drinks	2.00
Bar-B-Que	3.00	Beer (domestic light)	5.00
Masters Club	3.00	Crow's Nest	5.00
Ham & Cheese on Rye	3.00	Beer (import)	5.00
Classic Chicken Sandwich	3.00	White Wine (chardonnay)	6.00
		Bottled Water	2.00
BREAKFAST Served until 10 a.m.			
Chicken Biscuit	2.00	Muffin	1.50
Breakfast Sandwich	3.00	Fresh Mixed Fruit	2.00

We Accept-Visa-MasterCard-American Express and Discover

On the flip side, we wanted to show the prices for beverages at the Masters. Either inflation hasn't reached Augusta, or they don't need additional revenue from golf patrons. I never thought a domestic light beer at $5 would be considered a bargain, but that's our current environment in 2022.

It isn't just beer that we are disappointed in seeing such large YoY (year-over-year) increases in. Over the last year, dry cleaning and eggs are up +10%, coffee and bread increased +14%, milk and furniture +15%, bacon +18%, hotels and used cars are up +23%, airline tickets are +33% and gasoline +44%. Over the past year, electricity prices rose +12%, an increase that will translate to $540 in higher electric bills for the average American household. Ouch!

Back in 1977, Warren Buffett said that "inflation is a far more devastating tax than anything that has been enacted by our legislatures. The inflation tax has a fantastic ability to simply consume capital." There are a couple of lessons to take away from the late 1970's macro rollercoaster. First, during inflationary periods, sentiment and consumer psychology can play an important role. We will address investor sentiment (both retail and institutional) in a few pages. Secondly, the Fed needs to aggressively fight inflation, using all of its capabilities and techniques. During COVID, the Fed not only lowered rates towards zero, but it aggressively increased the size of its balance sheet. It might be necessary to tighten much quicker than incumbent administrations like, but the Fed must work hard to fight runaway inflation.

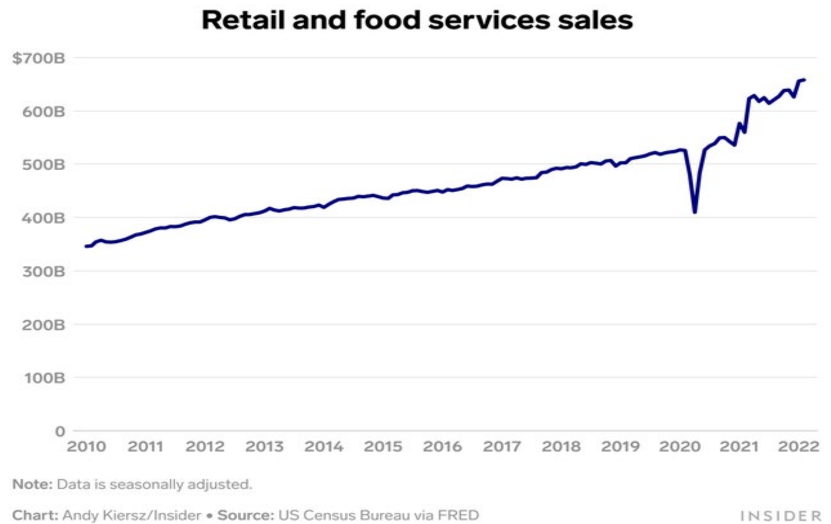
The truth is that nobody knows when inflation will peak or subside, or how long it will take to return to a more "normalized" environment. Instead of attempting to market time, we prefer to do deep fundamental research on our companies and understand how they actually might benefit from today's high inflationary conditions. Our research note isn't going to criticize the Fed for its prior decisions. Instead, we want to discuss how certain companies (i.e., payment companies) benefit from higher prices and inflation.

Spending:

One of the most important growth factors in our economy is consumer spending. It is estimated that consumer spending comprises 70% of GDP. Current data shows consumer spending increased by +0.9% in April, with March's figure revised higher to +1.4%. On the spending front, activity remains robust, and the US consumer continues to drive our economic vitality.

On GPN's 1st quarter conference call, CEO Jeff Sloan was asked about the effect of inflation on his business. His comments are insightful. Sloan said "So the short answer to your question is, we're not really seeing, I would say, any inflationary pressure, putting pressure on the consumer to a point that is changing behavior and slowing down the

overall level of spend in the market. So, with an inflationary environment, we're going to benefit as volumes continue to tick up, reflecting price inflation and the overall cost of goods and services that consumers are purchasing."



While many economists are calling for a 2023 recession, the current fundamentals don't lead us to that same conclusion. As this recent US Census Bureau chart shows, spending remains very strong. Retail and food service sales has steadily been climbing (for a decade), excluding the 1x blip from the global pandemic in early 2020.

Speaking at Bernstein's Strategic Decisions Conference in early June 2022, American Express CEO Steve Squeri had some positive comments on consumer spending trends. Squeri conveyed confidence in Amex's affluent customer base and stated that the overall economic environment was positive. He said Amex hasn't seen any notable deterioration in credit quality, with delinquencies and write-offs remaining under 1%. Specifically, he said "We feel really good about what we're seeing from a spend perspective. We can talk ourselves into a recession. I'm just not seeing it with the card base."

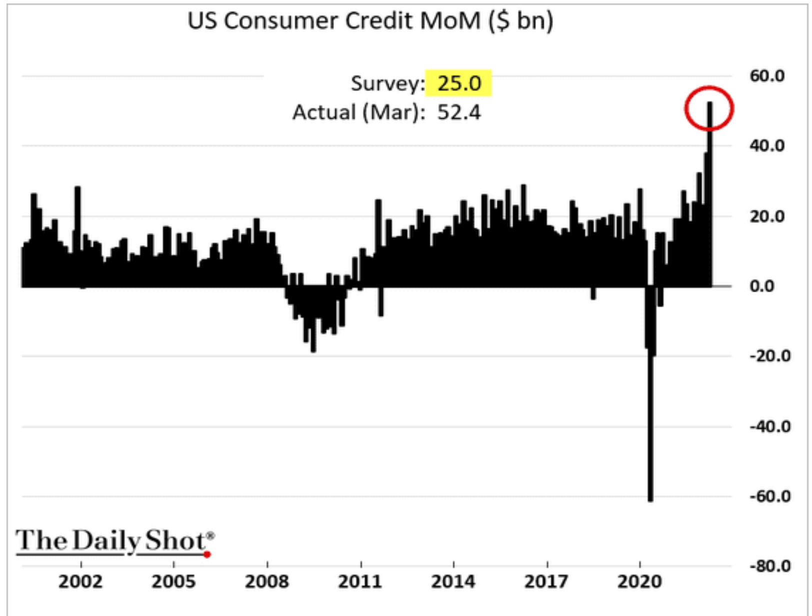
Visa's CFO is Vasant Prabhu and he recently spoke at a number of sell-side conferences. He continues to see strong consumer spending trends, even as retailers like Target and Wal-Mart lower guidance. Prabhu mentioned that Visa cardholders are spending more on services, after experiencing significant declines during the pandemic. This makes sense if you've done any personal travel recently. Airports, flights, and hotels seem overcrowded and jammed, right? Prabhu said "You're seeing the pendulum swing. And so, where we see the greatest growth right now is in things people couldn't do before like travel, like restaurants, like entertainment, and so on."

On the eCommerce front, Prabhu states that many are still "in the early stages of growth. So even in a recessionary environment, there's a large opportunity there". On the fundamental front (i.e., spending trends), on June 1st, 2022, Visa reported volumes and transactional data running over its network, through May 28th.

As the world's largest payment network, this can be viewed as a great insight into processing trends. QTD (quarter-to-date) trends remain quite positive, with US payments volumes rising +13% year-over-year. When we analyze these results, we try to exclude the global pandemic in 2020 and look at current results versus pre-pandemic figures. Using pre-pandemic 2019 as the baseline, US payment volumes are +148%, with credit and debit +140% and +157% higher respectively.

On the debit front, QTD US payment volumes increased only +4%, but credit volumes were higher by +23%. In our opinion, this is quite telling to see more US consumers utilize credit versus debit.

From a processor perspective, the margins on credit far exceed those of regulated debit. Looking at this chart (on the right), one can clearly see that more US consumers are using credit to transact. In fact, US credit hasn't experienced this large of a month-over-month increase in two decades.



Those that follow the payment players know that cross-border is the single highest margin transaction that occurs. For Visa, QTD total cross-border volumes increased +39% (on a constant dollar basis). Notably, through May, cross-border spending volumes exceeded 2019 levels by +132%.

It isn't just spending here in the US, but global consumers are transacting more frequently too. Visa's payments volume in both Latin America and the Middle East/Africa regions has doubled over the last three years. In early June, Mastercard released its monthly SpendingPulse report, through the end of May 2022. For the first time in this report, Mastercard broke out European countries, as well as trends it is seeing in physical versus online merchants. European spending trends are up dramatically from 2019. For example, retail sales in the UK are up +124% and France is higher by +131%. Also, we can even dissect how in-store trends are doing versus online. In France, online retail sales are up +27% and Germany is higher by +23%.

Our goal in mentioning these spending trends isn't to demonstrate that the US or global economy is perfect or that there's nothing to worry about. There are plenty of issues and headwinds, but we believe the positives far outweigh the negatives. By examining these spending trends, one can infer that the US and the global consumer has recovered and has eclipsed their pre-pandemic spending levels. This type of spending bodes well for processors and merchant acquirers, that assist retailers in accepting payments.

Sentiment:

Despite this fairly robust spending environment, the stock market (as defined by the S&P 500) is down over (20%) this year, which is the worst start to a calendar year since 1932. Both retail and institutional investors have been burned and sentiment remains poor. Since the start of the year, the S&P 500's market capitalization has fallen by over ($9.3) trillion, which is over a trillion dollars more than what was lost during the Financial Crisis.

The largest component of the S&P 500 is the IT (information-technology) sector, at 27.1% of the total index. Unfortunately for tech investors, this sector has fallen by over (25%) so far this year and it is its worst start to a year since 2002. The Nasdaq is now down (30%) from its high in November of 2021. The consumer discretionary sector (~11% of the S&P 500) and communication services (~9% of the S&P 500, and where Amazon now resides) are both down by (30%) this year. Other than energy (~5% of the S&P 500), up over +60% this year, there has been few places to hide this year.

As a recent Gallup data indicated, only 1% of its poll view current economic conditions as "excellent". Instead, 85% of Gallup's respondents view current economic conditions as "fair to poor". Looking forward, 77% of Americans expect the outlook to get worse. Another US consumer sentiment reading is done by the University of Michigan. Its US consumer sentiment reading fell to 50.2% in June, from an already low 58.4% a month ago. These are sentiment readings and lows not seen since 1980.

From an institutional perspective on sentiment, Bank of America (i.e., BoA) did a survey of global fund managers in April 2022. BoA inquired with these institutional managers about their biggest economic worry. 26% of managers believe a global recession is coming, 25% of managers are worried about hawkish central banks, 21% are fearful of inflationary pressures and 16% are concerned with the Russia and Ukrainian conflict.

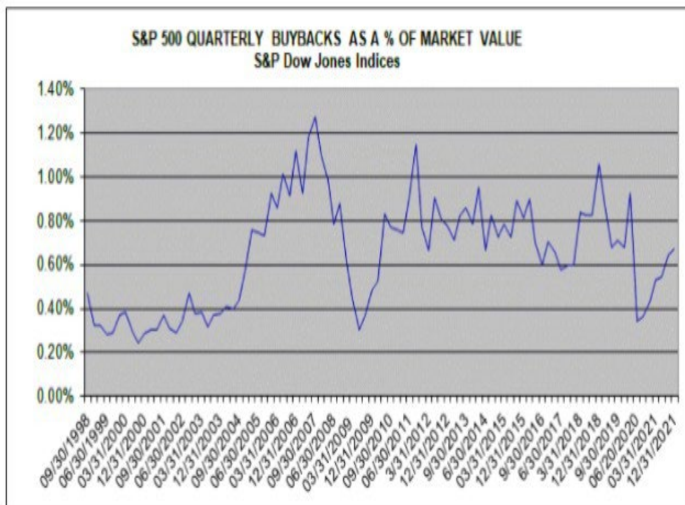
It isn't just institutional managers that are pessimistic, it is retail investors too. The Association of Individual Investors found that bearish sentiment is now above the "Dot Com" crash and approaching levels last seen during the Financial Crisis in 2008.

At recent conferences, some large card issuers and banks (i.e., BoA, PNC, American Express) expressed confidence in the economy, based on a healthy consumer. With a robust job market, rising wages, and a fairly high savings rate, these companies are expecting a healthy economy and solid spending. On the flip side, others are calling for a recession due to skyrocketing energy prices, a reduction in fiscal and monetary stimulus, rising interest rates and the impact from the Ukrainian / Russian war. JP Morgan's CEO Jaime Dimon is cautious and just stated he is getting his bank ready for an impending "financial hurricane."

While it never hurts to prepare for the worst, we are more confident. We see resilient consumer spending and solid household balance sheet strength. We are not forecasting a recession, but we are not macro economists; we are bottoms up, fundamental research analysts focused entirely on the emerging FINTECH industry. When we look at the current fundamentals, we see excellent growth ahead. While inflation is an obvious and powerful negative force on sentiment, it also may be so powerful that it causes investors to miss the parts of the economy that are growing and working well. From our perspective, today's negative sentiment is a somewhat bullish set-up, as a strong economy is being wildly under-appreciated.

In our opinion, it is impossible to time the market. History shows that investors do not want to be "left on the sidelines" when a surprising rebound occurs. Since 1974, the S&P 500 has increased an average of +8% one month after a correction bottom, and more than +24% a year after a correction bottom. Instead of being a short-term trader, Manole Capital is a long-term investor. Our process, strategy, and philosophy all rests on this long-term investment approach. We don't know when this mini correction will run its course, but it will end. Will a recession come in 2023? We truly have no idea, but we do not see the economic conditions that would merit that guestimate. We are confident that investing in growing, free cash flow generating FINTECH companies, trading at very reasonable valuations, is a good recipe for success. With sentiment so poor right now, one might wonder who is left purchasing company stock. Well, the answer is the companies themselves.

Buybacks:



If retail or institutional investors are not terribly excited about purchasing a stock, it is great to have a management team and Board of Directors that is able to step up and "fill that void".

As this chart shows, certain S&P 500 companies have been ramping up their share repurchases. Back in 2006 to 2007, before the Financial Crisis, many companies were buying back significant amounts of their own stock.

Over the last decade or so, this has trailed off. However, it looks like those companies with strong free cash flow and a healthy balance sheet, are beginning to examine the benefits of reducing the share count. Some are simply trying to offset aggressive equity grants, but others see the value in lowering the absolute number of shares outstanding.

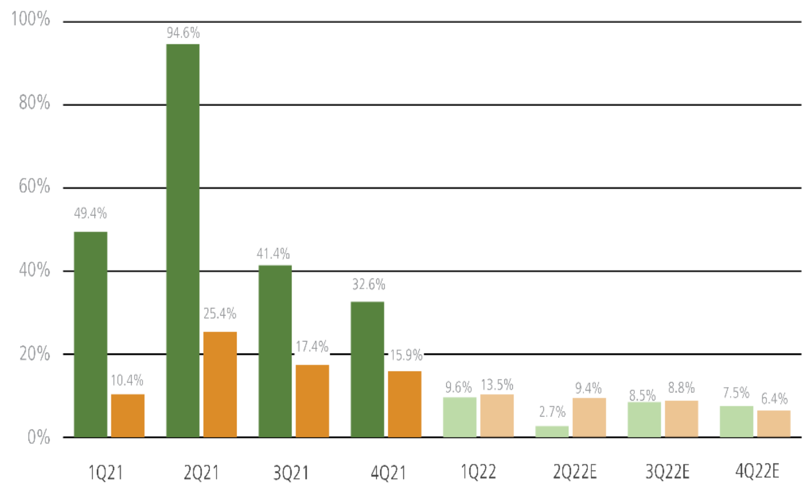
GPN has an authorized buyback of $1.54 billion remaining, which we believe it can accomplish over the next 12 months. This follows GPN spending $2.5 billion on repurchasing its shares in 2021. If it decides to pause its acquisitions, and to let some pricing reset, it might even get more aggressive with it repurchases.

If one considers that GPN's stock is trading near an all-time low valuation, we would certainly advocate a more aggressive buyback. The company has employed ASR's (accelerated share repurchases) in the past, to accomplish its buyback more efficiently. We won't be surprised to see GPN authorize another $1 billion to $2 billion (~ 4% to 5% of market cap) buyback.

Recent Market Results:

Looking at the recently reported quarter (for the S&P 500), 1st quarter sales grew +13.5%, while earnings were up +9.6%. With earnings growing slowing than the top-line (i.e., negative operating leverage), some companies are struggling to deal with a challenging pricing environment, as well as higher input and labor costs. Other issues like rising inflation, the Ukrainian / Russian war, and lockdowns in China have all contributed to this uncertainty.

In the 1st quarter, 3/4th's (77%) of all S&P 500 companies reported a positive EPS. However, many of these companies saw their shares decline in the two days following their earnings release. As we often discuss, the stock market is always looking forward. While the prior quarter is helpful to understand how management has performed, it is much more important to look forward and to understand where a company is going. What are future expectations? What is management's forward guidance? What are the challenges? How will the company react in various scenarios? Even if a company exceeds last quarter's results, it is always more important to understand where sentiment and expectations (both buy-side and sell-side) lie.



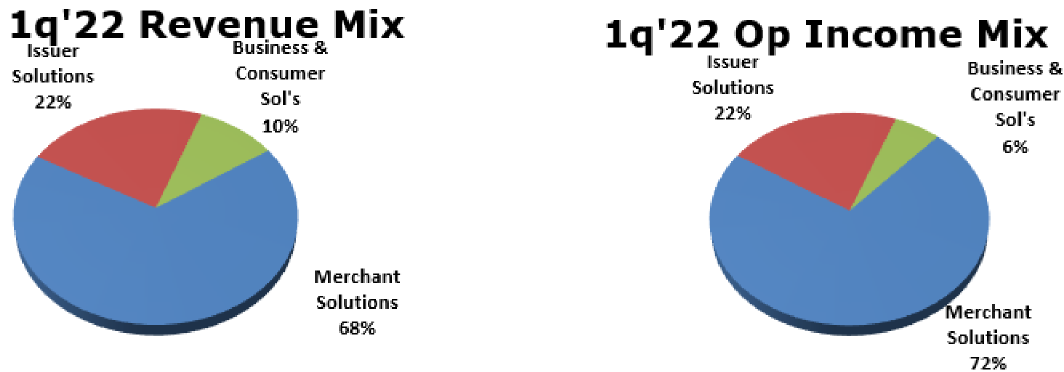
Looking at this chart from Zacks, one can clearly see that 2022 has some difficult comps (i.e., compares). 2021 easily outpaced the challenging 2020 year, so 2022 is returning to more normalized conditions.

While the earnings landscape is constantly shifting, we are pleased that many of our payment companies are outperforming the market and delivering predictable results. We are not seeing many of the same supply chain or glaring issues that are getting reported in the financial media.

GPN Fundamentals:

Before we get to GPN's attractive valuation, we should spend a few minutes on their business and underlying fundamentals. For starters, GPN has two key segments: Merchant Solutions and Issuer Solutions. There is a 3rd segment called Business and Consumer Solutions, but it remains a small component of the total mix.

The two-pie charts below indicate the mix of revenue and profits in GPN's latest reported results.



Merchant Solutions should grow revenue in the mid-teens and post operating margins approaching 50%. Earlier, we discussed how GPN was moving from simply providing card processing to merchants to other value add services. In the 1st quarter, GPN had 36% growth in their vertical market bookings, 30% growth in HCM and Payroll offerings and 50% in POS software growth. Clearly, GPN isn't just a merchant acquirer or card processor to its clients.

The Issuer Solutions business is primarily the business that GPN purchased in its Total Systems acquisition in 2019. This segment is growing at a slower pace, but it still generates solid free cash flow. This year, Issuer Solutions will only modestly grow, but it should expand operating margins into the low 40% range.

In 2022, GPN should generate 10% revenue growth (slightly higher excluding currency fluctuations), operating margin expansion of +125 basis points and adjusted earnings growth in the high teens to 20% (excluding currency). Maybe even more importantly, GPN is able to turn earnings into free cash flow, with 100% conversion of net income to FCF. This implies FCF approaching $2.6 billion in 2022 or a yield of 7.4%. With debt to EBITDA under 3x (a stated management target), we believe GPN does not need to paydown its debt. Instead, its impressive FCF can go towards re-investing back into their business, accretive acquisitions, increasing the dividend and especially towards stock buybacks.

GPN Performance:

We have owned GPN for over 15 years and have generally been pleased with its performance. We built this performance grid to highlight how GPN has performed versus the S&P 500.

	Performance:														
	'08	'09	'10	'11	'12	'13	'14	'15	'16	'17	'18	'19	'20	'21	'22 YTD
YE Price	$16.40	$26.93	$23.10	$23.69	$22.65	$32.49	$40.37	$64.51	$69.41	$100.24	$103.13	$182.56	$215.42	$135.18	$128.88
GPN	-29%	65%	-14%	3%	-4%	44%	24%	60%	8%	44%	3%	77%	19%	-37%	-4%
SPX	-37%	26%	15%	2%	16%	32%	13%	1%	12%	22%	-4%	31%	18%	29%	-12%
vs BM	+	+	-	+	-	+	+	+	-	+	+	+	+	-	+

Outperformed S&P 500 in 10 out of last 14 yrs & 4 of the last 5 yrs

Since the Financial Crisis in 2008, GPN has outperformed the overall market in 10 of the last 14 years. It has also outperformed the market in 4 out of the last 5 years. Last year was a challenging year for most payment stocks (GPN was down 37%), while the market rose +29%. This year, while the market is off to a tough start, GPN is down less (i.e. relative outperformance of ~ 800 basis points).

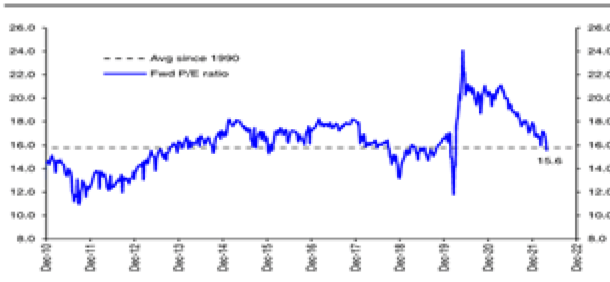
As this 5-year GPN chart shows, 2019 and 2020 were excellent years for performance. Then, starting in mid-2021, GPN (and many payment stocks) began to trail off. Was this due to stock-specific issues (i.e., PayPal rumored purchase of Pinterest or Square's $29 billion acquisition of Afterpay) or was it industry-wide?

2021 was the worst year for payment stocks since 2010, when Senator Dick Durbin (Democrat from Illinois) passed his Durbin Amendment inside of Dodd-Frank legislation.

We believe this trailing 12-month payment stock weakness creates an interesting opportunity to purchase wonderful businesses at attractive valuations.

Market Valuation:

Now, let's take a look at the overall stock market, which we like to use the S&P 500 as our proxy.



In 2022, per Zacks Research, expectations are that the S&P 500 will grow both revenue and earnings by 10%. In 2023, expectations are that the S&P 500 will grow revenue by only 7% and earnings by 6%. For this modest growth, the S&P 500 is trading at a P/E of 16.8x 2022 and 15.8x 2023.

If we go back to 1990, as this Scotiabank and Bloomberg chart does, we can see that the average forward P/E multiple is 15.6x.

With a forward multiple very close to its 30-year average, the stock market isn't terribly expensive or cheap - just average.

GPN Valuation & Price Target:

In comparison to the overall market, looking at 2023 estimates, GPN is growing its revenue 2x to 3x faster than the S&P 500 (19% versus only 7%). On EPS, GPN is growing 3x faster than the market (18% versus 6%). Lastly, in a profit comparison to the average company, GPN's operating margins are 41.1%, while the S&P 500 generates pre-tax margins of only 23%. So, GPN grows faster and has significantly higher profitability than the average company in the S&P 500.

In our opinion, FCF is the most important valuation metric to follow. Over the last few years, the market has embraced revenue multiples, but we refuse to do so. One of our most important rules is that all of our positions must generate FCF. Last year, GPN generated $2.4 billion in FCF, and it should climb by 10% to $2.6 billion this year. That implies a FCF yield of over 7%.

However, for the methodology of generating a GPN price target, we will lean towards using a forward P/E multiple and a traditional EV (enterprise value) to EBITDA calculation. We started by trying to gauge how GPN is ranked versus its peers. Looking at eight of GPN's payment peers (EVOP, EVTC, FISV, FIS, FOUR, MA, PYPL and V), we see

that GPN is the cheapest name in the group (based upon 2023 forward P/E multiples). This payment universe of companies trades at a forward P/E multiple of 21.4x and GPN is at a 44% discount to this peer group. Using that 21x average forward P/E, on GPN's 2023 EPS would be a target of $228.50 per share or over 75% of upside.

Below, we are providing the last 3, 5 and 10 years of valuation data, in terms of forward P/E and EV to EBITDA. This data shows the average, high and low valuations over these various time periods.

Fwd P/E	**3-Yr**	**5-Yr**	**10-Yr**
Average	21.3x	21.2x	18.6x
High	27.3x	27.3x	27.3x
Low	11.6x	11.6x	10.4x

EV / EBITDA	**3-Yr**	**5-Yr**	**10-Yr**
Average	16.2x	15.5x	12.8x
High	31.9x	31.9x	31.9x
Low	9.8x	9.8x	4.0x

As of today (June 13, 2022), consensus expectations for GPN are as follows (per Zacks Research):

	2022:	**2023:**	**YoY:**	**Valuation:**
Revenue	**$8,414**	**$9,172**	**19%**	
EBITDA	**$4,005**	**$4,427**	**11%**	**10.1x**
Adj EPS	**$9.09**	**$10.69**	**18%**	**10.5x**

In terms of upside, if we take the average forward P/E of 21x (3 year or 5 year), using 2023 estimates of $10.69, we arrive at a price target of $224.28 per share or 100% of upside. This is significant upside, so to be conservative, we would prefer to use the 10-year average of 18.6x. Using this lower forward P/E, we arrive at a price target of $198.65 per share (rounding to $200), equating to over +75% upside from today's price. We would be comfortable even discounting that further, to conservatively expect *just* +50%.

If we take the average 5-year EV to EBITDA multiple of 15.5x, on $4.4 billion of 2023 EBITDA, we arrive at a price target of $210 per share or +88% of upside. If we simply average these two valuation methods (P/E and EV / EBIDTA) or equally weight them, we arrive at a 12-month target of $205 per share or +83% of upside for GPN.

In terms of downside, if we take the low forward P/E of 11.5x, on lowered consensus 2023 earnings of only $10.50 (2% lower than consensus) per share, we arrive at a price of $120.75 per share or close to today's share price. In our opinion, that equates to almost a "worst case scenario". While things could always get worse, using a low forward P/E on lowered estimates, provides a modest amount of downside protection. Plus, as we mentioned earlier, we believe additional protection will come from GPN aggressively re-purchasing its stock.

Historically, private equity gets interested in payment companies that trade at an EV to EBITDA level of 8x to 10x. At just 10.5x 2023 EBITDA expectations, we would expect GPN to garner some potential interest. It would likely be a big deal for a private equity firm to purchase (over $40 billion), but many of these firms (i.e., Apollo, Bain, Blackstone, Carlyle, KKR, TPG, etc.) are sitting on records amounts of capital to deploy.

We like the risk versus reward proposition of (5% to 10%) downside versus +50% upside opportunities.

Concerns:

The Total Systems acquisition, in May 2009, was a $21.5 billion deal. This was far and away the largest acquisition that GPN ever made. Back in December of 2015, GPN acquired Heartland for $4.3 billion, but Total Systems was 5x larger.

The Total Systems acquisition followed the First Data and Fiserv deal, as well as the Vantiv/World Pay and FIS transaction. Did GPN react to its peers? Was it forced into a deal to simply compete? Was it forced to combine with a competitor to have enough scale? Did it overpay for Total Systems? All of these are valid issues, but it is "water under the bridge", at this point in time. The reality is that GPN did purchase Total Systems and investors need to examine whether the combined entity has a bright future or not.

In our opinion, the Card Solutions business is "fine". Its margins are impressive, in the 40% range, it generates significant FCF, but it seems unable to grow materially (just a few percent annually). There are some interesting assets that can be retained or potentially sold (i.e., Netspend, one of the largest reloadable, pre-paid card provider). More importantly, there should be solid cross-selling opportunities, with large financial institutions that utilize its Total Systems AOF (account on file) card solutions.

We typically like doing sum-of-the-parts valuation analysis, especially if management seems keen on potentially breaking up a business into smaller (more valuable) pieces. However, we haven't bothered to do this for GPN. Why? Well, if we valued the Card Solutions business at its closest peer (Marqeta, ticker MQ), we would arrive at a ridiculously high valuation. MQ does not generate any FCF and won't be EPS positive for 4 to 5 years. As we mentioned earlier, we refuse to utilize revenue multiples, as it reminds us too much of the "Dot Com" era - when companies were valued off of page views and eyeballs. As of now, MQ trades off of a revenue multiple of 6.5x. If we used this flawed valuation metric on GPN's Card Solutions business, it would imply too much upside to realistically mention.

On May 31, 2022, GPN's CFO (Paul Todd) announced his decision to retire. Prior to becoming GPN's CFO, Mr. Todd was CFO of Total Systems (July 2014 to September 2019) and President and CEO of Synovus Financial Management family of companies (2007 to 2008). In just a few days, GPN replaced Mr. Todd with Josh Whipple (age 49), its current SVP of Strategy and its Enterprise Risk Officer. Mr. Whipple has been with GPN since 2015 and must have a good relationship with its Chairman / CEO Jeff Sloan and President / COO Cameron Bready. In fact, CEO Sloan said "He (Whipple) is a trusted partner who has played a key role in building the leading technology enabled, software-driven payments business worldwide that Global Payments is today". It is nice to have a deep bench to replace one executive with a capable internal replacement.

Anytime a senior executive departs, there should be some level of concern. For example, when PayPal had its CFO depart for Wal-Mart, it was only a matter of months before forward guidance was altered. While it is nice that Paul Todd will continue to serve as a senior advisor assisting with Mr. Whipple's transition, we do find it odd that Mr. Todd is retiring at the age fairly young age of only 50. Maybe he was more of a Total Systems guy, not necessarily a GPN guy, having spent over 15 years at its predecessor?

One of the last concerns we want to address is GPN's market share. As we have stated several times, there are no shortage of companies willing to handle payments for merchants. Not all have the capabilities to handle the more laborious process of card transactions, but essentially any salesforce can become a merchant acquirer and outsource the processing.

GPN recognized how competitive this business was getting and was the first to migrate towards an ISV model. This has taken a number of years to develop, and it will take a decade longer to ultimately permeate throughout the industry. Using Nilson data to determine which firm has the leading number of transactions or the highest dollar volume of purchases misses the bigger picture. The key, at least in our opinion, is to retain your customers and become an integral component of their success. As your clients do well, you can succeed with them. That is what we strive to do (at Manole Capital), and it is exactly what we believe GPN has built.

Conclusion:

What is a *"Diamond in the Rough"* stock? Webster identifies this phrase as "one having exceptional qualities or potential but lacking refinement or polish." For us, it is a company that generates excellent free cash flow, has a business model benefitting from secular growth opportunities, impressive and sustainable margins, as well as trading at an attractive valuation. GPN checks all of these boxes and more.

Instead of simply competing in a never-ending price war, processors are using technology to provide a better product. In years past, the barriers to entry were small. An acquirer could knock on the door of a merchant, lower price and win business. Now, technology, software capabilities and integration make this discounting irrelevant.

The disappearance of cash and checks continues to create a strong tailwind for all payment participants. The secular growth of electronic and card-based payments will last for decades. A deeper analysis reveals how certain paymemnt players, if they maintain and expand the services offered to their clientele, can reduce attrition, and successfully grow.

In our opinion, GPN has significant upside potential, with only modest downside risk. The valuation is appealing, the growth outlook is promising, but the stock remains "stuck in the mud". We believe this will change, as the company posts "beat and raise" quarters in 2022 and 2023. Management will lift the dividend towards 1.5%, but the primary use of FCF will go towards accretive acquisitions and material share repurchases. The overall market might not value GPN's business, but the company is willing to put its money to work by buying back a significant amount of its shares. We believe this is a wise move by the Board, which will pay off handsomely for its shareholders.

As we highlighted, the payment sector is undergoing a radical, but positive shift. For the foreseeable future, many payment companies will benefit from these secular growth trends. While the current environment and investor sentiment is poor, the fundamentals of GPN remain resilient. Most investors have never heard of GPN, but do know its payment peers like Visa, Mastercard, Square and PayPal. GPN's name might not be readily known, but its beauty becomes apparent with detailed analysis. In our opinion, now is an excellent time to do research on GPN and see if it merits a spot in your diversified equity portfolio. Maybe it is that *"Diamond in the Rough"* stock you've been waiting for.

Warren Fisher, CFA
Founder and CEO
Manole Capital Management

MANOLE CAPITAL MANAGEMENT

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