Jackson Hole, Wyoming:

Each year since 1978, Fed officials meet up in Jackson Hole, Wyoming to discuss the financial and economic backdrop. The Federal Reserve bank of Kansas City hosts central bankers, economists, and financial experts to discuss monetary policy, interest rates, and the global economic environment. While 99.99% of the general population isn't terribly interested with the longest-standing central banking conference in the world, the symposium is a "who's who" in economic circles. Sounds very exciting, right?

Following COVID, many experts are struggling to understand the repercussions on pricing, labor markets, inflation, and debt levels. Chairman Jay Powell just made his 6th Jackson Hole speech, and he is trying to craft an effective monetary policy that "threads the needle"; taming inflation with higher interest rates, while ensuring there isn't a severe downturn and recession. It is clear that the Fed erred in thinking that inflation was "transitory", back in 2021. However, we personally are willing to cut Chairman Powell a little slack. He has an unbelievably challenging job, navigating so many disparate variables. The pundits love to criticize his decisions, but that's seems like Monday morning quarterbacking to us.

For two decades, the Fed (under four different leaders) struggled to reach its 2% annual inflation target. Now, it is doing everything in its power to return to that level. This magical 2% level was beginning to get questioned, and some were calling for the Fed to use a 3% or 4% inflation target. When asked about that, Chairman Powell said, "Two percent is and will remain our inflation target. We are committed to achieving and sustaining a stance of monetary policy that is sufficiently restrictive to bring inflation down to that level over time."

A year ago, at the Jackson Hole symposium, Chairman Powell was clear and concise, delivering a very brief and dramatic (less than 10 minutes) speech. His hawkish commentary led to a stock market sell-off, as he vowed to tame inflation regardless of economic pain or outcome. This year, Chairman Powell re-iterated his focus on getting inflation under control, but it was much more of a "middle-of-the-road" type of message. He continuously said that the FOMC (Federal Open Market Committee) will proceed carefully, cautiously, and judiciously.

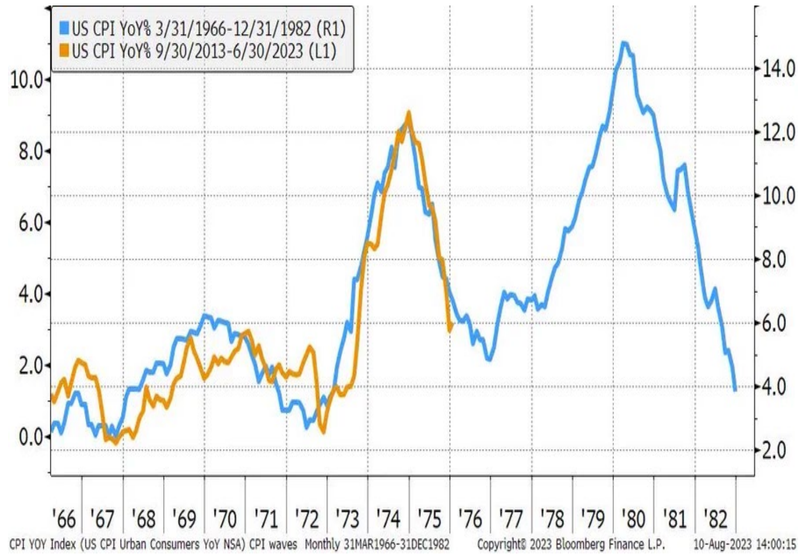
Compared to a year ago, inflation is down by roughly two-thirds, unemployment is miniscule, and the economy continues to nicely expand. The Fed's preferred inflation gauge is the PCE (personal consumption expenditures) index and while it is declining, it is still too high and sticky. Of course, the Fed will remain data dependent and keep all of its options on the table. Core CPI is still at +4.7%, unemployment is remarkably low at 3.5% (a 50-year low), while GDP remains solid at +2.4%. In fact, the Atlanta Fed's GDPNow model is projecting an exceptionally healthy 3rd quarter GDP of +5.9%. Nobody was calling for a soft landing a year ago, but the Fed is directing a fairly resilient and robust economy (with the exception of March's banking volatility).

Higher for Longer?

The Fed continues to emphasize that it intends to keep interest rates "higher for longer". Following their last rate increase, Fed Funds reached a 22-year high. Chairman Powell closed his Jackson Hole speech with the following quote, which we believe counters some of those experts expecting lower rates. He said, "Although inflation has moved down from its peak - a welcome development - it remains too high. We are prepared to raise rates further if appropriate and intend to hold policy at a restrictive level until we are confident that inflation is moving sustainably down toward our objective."

Chairman Powell continues to emphasize that interest rates could stay high for the foreseeable future, keeping borrowing costs elevated. James Bullard, the longest tenured of the twelve regional Fed Bank presidents, continues to emphasize a similar message. Despite him stepping down from his role on the Fed, Bullard thinks the US economy is delivering stronger growth that could require higher interest rates to fight inflation. In an interview before Jackson Hole, Bullard said central bankers should be pleased with how the economy has performed this year but indicated that it (the Fed) should lift them again this fall. He specifically said, “The Fed might have to raise rates even more, if the recent economic acceleration continues in the coming months and I don’t think markets are really ready for that.”

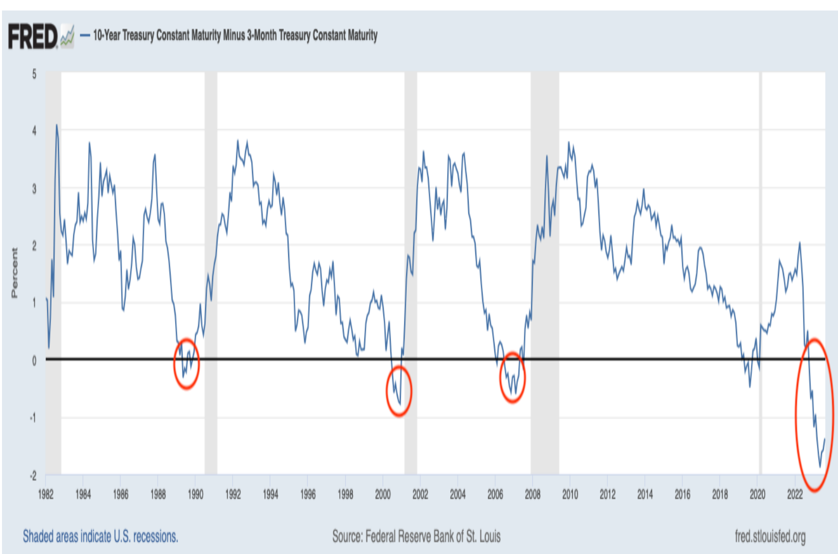
Similar to Bullard’s comments, former Secretary of the Treasury (1999 to 2001) and former president of Harvard University, Larry Summers believes we shouldn’t assume that inflation is permanently headed back to that 2% target. He created this chart comparing the time periods of March of 1966 to December of 1982 versus September 2013 to now. As his analysis and data shows, prices could potentially see a sharp reversal and head materially higher.



While monetary policy remains restrictive, it has been somewhat offset by a stimulative fiscal policy. Historically, fiscal stimulus occurred at the end of recessionary periods to spur growth. However, massive fiscal stimulus was enacted before this downturn, which has helped keep that looming recession away. Both interest rate hawks and doves believe we are near the end of the rate hike cycle, but the Fed isn’t as convinced.

Inverted Yield Curve = Recession?

With the Fed shrinking its balance and raising interest rates eleven times, the yield curve became inverted. The experts immediately began calling for a recession, since inverted yield curves have preceded every US recession since 1969. In fact, 100% of economists surveyed by Bloomberg last October, were predicting a recession in 2023.



As this chart from the St. Louis Fed shows, there is a high correlation between inverted yield curves preceding economic downturns. Historically, an inverted yield curve (of at least two months) has led to a recession within the next 18 months. Over the last 50 years, an inverted yield curve has been one of the most reliable predictors of an imminent recession.

Typically, a positively sloping yield curve benefits banks, as their NIMs (net interest margins) can be profitable and high. Banks - and their lending - are the lifeblood of our economy. If there are profitability issues with their lending or if they institute tighter credit conditions, it could obviously hamper economic activity.

The worry is that an inverted yield curve can lead to a financial crisis, which could turn into an economy-wide credit crunch and recession. We believe that it is credit crunches that often cause recessions, not inverted yield curves (that simply anticipate those events). While the inverted yield curve did correctly anticipate a banking crisis, the Fed responded quickly with its emergency bank liquidity facility that helped avert a critical “run on the banks”.

Interest Rates:

As always, we won't be providing any macro forecasts or predictions. We will continue to monitor the CME's FedWatch tool, to understand what the market is expecting for interest rates. As of now, one might expect rate cuts in May, July, and September next year for America, the Eurozone and Britain. Following Jackson Hole, traders put higher odds that the FOMC will raise interest rates at one of its next two meetings. Odds for a quarter-point rate hike in November went from 42% up to 48% and the chances of a half-point rate increase rose from 7% to 9%.

The yield curve will eventually unwind, but the key question will be how this occurs. Will the economy enter a recession, forcing the Fed to cut interest rates on the short end of the curve? Or will investors absorb higher short-term rates and push long-term rates higher? Regardless of the future path of rates, we remain confident that our companies (that all generate free cash flow) will be able to manage through this volatility.

Banks:

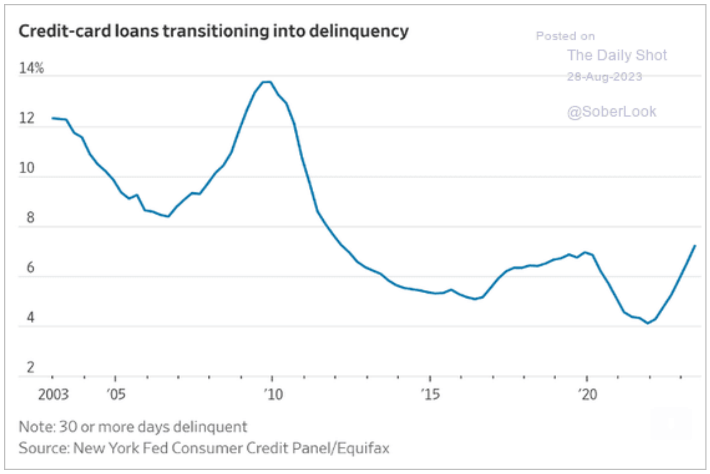
In our opinion, it is important to examine bank balance sheets, to understand liquidity and where the risks lie. After bank deposits peaked in mid-April at a record $18.2 trillion, they have fallen by nearly a trillion dollars. Bank loans remain at a record high of $12.1 trillion, as banks continue to lend, but only if the credit is sufficient and the interest rate justifies the underlying risk. Banks held a record $5.8 trillion in securities in mid-April and it has fallen by $645 billion to $5.2 trillion. Following the banking volatility in March, it is critical that banks stay liquid, but also use their deposits and balances to make loans.

As we just discussed, an inverted yield curve can crimp bank profitability. However, the amount of fiscal stimulus injected into the economy has been historic. We are trying to understand the future role of banks in growing our economy and how fiscal stimulus has impacted traditional lending. What if the economy is so flush with liquidity and capital that it doesn't impact our economic growth? Could the trillions of dollars of COVID-era stimulus have offset some of the negative effects of the inverted yield curve? There aren't any real historical precedents to help us answer these questions, but we are constantly looking at various key metrics and indicators impacting our FINTECH companies, as well as the financial sector.

Credit Cards & Debt:

As we discussed in our 1st half of 2023 Reflections note (click here), we continue to closely monitor how reliant upon credit cards the US consumer remains. The total number of credit card accounts reached 578.4 million, up 5.5 million year-over-year. In the 2nd quarter of 2023, revolving credit card balances topped $1 trillion for the first time and were up +4.6% in June. On a per person basis, that equates to over $3,000 of outstanding credit card debt per man, woman, and child in the US. According to JD Power, for the first time ever, the number of Americans rolling credit card debt (from month-to-month) is now higher than the number of people paying their bills in full. High interest rates compound the problem, making it a costly debt for consumers. Since the Fed started keeping track of credit card APRs (annual percentage rates) in 1994, the average exceeds 20%.

We track and monitor credit card delinquencies and charge-off's to understand the health of the American consumer. We aren't thrilled to see 90-day delinquencies climb from 3.35% a year ago to 5.08%. In the 2nd quarter of 2023, the 30-day delinquency rate was 7.2%, which was the highest it has been in 11 years. Last quarter, American Express's profit declined (13%) year-over-year, while Discover's fell by (21%). According to Capital One's earnings results, the allowance for losses in its credit card portfolio was slightly under $11 billion, or 7.7% of total assets. This is an increase over the +6.7% ratio recorded a year ago, but below the double digits it experienced at the end of 2020.



Note: 30 or more days delinquent
Source: New York Fed Consumer Credit Panel/Equifax

As this chart from the New York Fed and Equifax shows, the 30-day credit card delinquency trends are rising (now above pre-COVID levels), but they are not even half as bad as they were during the Financial Crisis. In the New York Fed's quarterly credit report, it stated that "while delinquency rates have edged up, they appear to have normalized to pre-pandemic levels."

Clearly, the US consumer is relying more and more on credit and has drained some of their 2021 stimulus savings. Credit card balances add to the total amount of household debt, which now stands at a whopping $17.1 trillion. This is the highest level since the New York Fed began collecting debt data. At some point, excessive debt can become a troubling burden. As of today, it seems somewhat manageable.

As a reminder, Manole Capital prefers payment processors, merchant acquirers, gateways and networks and avoids the credit sensitivity of card issuers. Regardless of which entity is ultimately "left holding the bag", we feel it is important to continue to monitor these payment trends.

Speaking of payment trends, it has been 8 years since we published a stock specific note on PayPal (ticker PYPL). If you click on www.manolecapital.com/research, you can re-read that note from September 2016. In it, we specifically discuss how PayPal could begin to monetize its Venmo asset, following its spinout from eBay.

Here's a picture we recently took at a retailer's point-of-sale. While PayPal and Venmo are not yet as universal as Visa and Mastercard, more and more retailers are beginning to accept other brands.

Following some difficult performance of late, we thought it might be helpful to examine what's going on with PayPal.

The PayPal Opportunity, Note #2:

Taking a macro perspective, the market is finding it difficult to generate growth. For the S&P 500 during the second quarter of 2023 (with over 480 firms already reported), companies posted modest annual revenue growth (only +0.8%) and earnings fell by (8.5%). We like to differentiate between cyclical and secular growth and prefer our holdings to have long-term opportunities that are steady and predictable.

Manole Capital exclusively focuses on the emerging FINTECH industry and believes the quintessential FINTECH business is the payment sector. Many payment companies generate recurring revenue (i.e., revenue per swipe), have extremely attractive operating margins, impressive free cash flow and consistently strong earnings growth. When strive to identify secular growth businesses, generating solid free cash flow, and trading at a material discount to our calculation of their intrinsic value. For us, this can be a winning trifecta. We believe PayPal is one such company and this note will attempt to layout the merits for an investment at today's prices. We published a research note on PayPal, following its spin-out from eBay. The stock was languishing post-spin, and we believed there were several positive catalysts once it got separated from its parent.

Performance:

From mid-2015 (its spin) through March of 2020 (pre-COVID), PayPal performed quite well. As you can see in this Yahoo! Finance chart (on the left), it materially outperformed the S&P 500, as well as the Nasdaq.

When COVID arrived, millions of consumers increased their online shopping. PayPal is a natural beneficiary of digital payments, and its business was one of the positive outliers from the global pandemic.

In fact, PayPal hit an all-time high in July of 2021, when its stock price rose to $308.58 per share. This assigned PayPal a market capitalization of over $300 billion and it briefly eclipsed the size of payment rival Mastercard (ticker MA).

As this Yahoo! Finance chart plainly shows (below), the stock is down over (80%) from that peak. There are several reasons for this decline, and we will identify a handful of issues and causes.

Acquisitions:

As the stock was steadily climbing in 2021, basking in the glow of robust online shopping, a rumor emerged that PayPal was potentially interested in purchasing social media company Pinterest for $45 billion. While nothing ultimately occurred, some worried that it signaled that management was looking outside of its core competency for future growth.

Over the years, PayPal has been quite acquisitive. It acquired Braintree and Venmo for $800 million in 2013. When it was still apart of eBay, it acquired Xoom (money transfers remittances primarily to India and China) for $890 million in 2015. Also, that year, PayPal acquired Paydiant for $280 million, as it wanted to build-out its mobile wallet applications. Then, in 2018, PayPal made its largest acquisition ever, purchasing iZettle for $2.2 billion. Right before iZettle was slated to go public, PayPal purchased the European and Latin American smartphone payment company. Other deals were made, with TIO Networks in 2017 for $233 million and Swift Financial for another $183 million. Then, in 2019, PayPal veered from its payment focused deals and acquired Honey for $4 billion. Honey still exists, but it is an intrusive browser add-on providing coupons and deals to shoppers. Over the last 20 years, PayPal has made over two dozen acquisitions with varying degrees of integration success. In our opinion, Braintree and Venmo was its most successful, while the larger iZettle and Honey were its biggest whiffs.

If PayPal did acquire Pinterest in October of 2021, we believe it would have been even worse, if its (80%) decline wasn't bad enough. Some companies are good at tuck-in acquisitions and properly integrating them. In the FINTECH space, we would argue that Fiserv (ticker FI) has shown a solid track record of deals, dating back a couple of decades ago to its wonderful CEO Les Muma.

We always prefer our companies to exhibit strong organic growth, as opposed to acquiring their growth via deals. Also, it can be a challenge to properly integrate platforms and technology in the payments space. Lastly, it comes down to the old adage of "build or buy". Could PayPal have spent the money to build these capabilities on its own? Did it make the decision to purchase these companies to gain speed to market? We always like our companies to pay a fair, but not excessive price for deals.

Unfortunately, PayPal management has a spotty acquisition track record, especially when it veers from its payment expertise. Over the last couple of years, it appears that management has pulled back from its acquisitive ways. After spending $2.8 billion in 2018, $1.3 billion in 2019, $3.8 billion in 2020 and $3.1 billion in 2021, over the last 18 months, PayPal has only made $0.4 billion of deals. Instead of making costly and questionable acquisitions, PayPal has repurchased $4.9 billion and 63 million of its own shares over the last twelve months. Now, some might argue that these buybacks were a poor decision, with the stock plummeting. We agree, but companies are historically terrible buyers of their own stock and very few investors are skilled at market timing. We take some solace that there is ample liquidity available to repurchase additional shares, especially since the valuation of PayPal is so appealing.

Management:

Dan Shulman has led PayPal for nearly a decade, becoming its CEO on September 20th, 2014. His career is quite interesting, starting with 18 years at AT&T. Following that, he spent 2 years as the CEO of Priceline. Shulman returned to the phone industry again and helped grow Virgin Mobile, with the blessing of Sir Richard Branson and Sprint. Under Shulman's leadership, Virgin Mobile handsomely grew and had a successful IPO in 2007. With the cellular carrier sale to Sprint in 2009, Shulman briefly joined as its President. Following a few years in the cellular industry, Shulman joined American Express to lead their mobile and online payments business. It was this job and experience in payments that led to his hiring as the CEO of PayPal.

Shulman, known for his love of wearing cowboy boots, helped steer PayPal from its spin from eBay in 2015. In February of 2023, Shulman announced that he would be retiring as CEO. He successfully led its exit from eBay and grew the franchise to its current state, with over 430 million accounts. This is commendable and many view his leadership in a positive light, but the last year and a half has been challenging. The stock has grossly underperformed the overall market, the Technology sector and especially the FINTECH group. We are sure that he planned on retiring on a high note, but his tenure officially ends with a whimper. Over the last decade, we would argue Shulman's two biggest accomplishments were the spinout from eBay and the purchase of Braintree (including Venmo).

However, from February to August of this year, it seemed like PayPal was adrift. Following Shulman's retirement announcement in February, it appeared that there was 6 months of waiting and waiting and waiting. Investors were wondering when an announcement would be made, until Alex Chriss was appointed the new CEO in mid-August. Without a focused leader at the helm, PayPal seemed to just decline. Late last year, Elliott Management emerged as a potential activist investor in PayPal. For numerous reasons it failed to disclose, Elliott recently exited its PayPal position. Without positive results and execution, as well as no true leader, PayPal's stock languished.

We have covered Intuit (ticker INTU) for 25 years and believe it has numerous growth engines with Quickbooks, MailChimp and Turbo Tax. Alex Chriss comes from Intuit's Consumer division, where he led their small business franchise for the last five years. In our opinion, Alex is coming onboard at a perfect time. While there are numerous challenges facing PayPal, we believe the upside opportunities are enormous. We believe this represents an inflection point in PayPal's history. The last real identifiable point was the spinout from eBay. Now, there is a bit of a "changing of the guard", with Alex Chriss taking over.

Looking at Intuit's Quickbook franchise, we see an asset that dominates the small business accounting landscape. Over the years, it has added merchant acquiring, payroll, HR, and various other recurring revenue services. Specifically, the biggest deal the Consumer division executed was the $12 billion acquisition of Mailchimp in September of 2021. Intuit seems to have absorbed this successful (and private) company, while adding another feature to its Quickbooks core franchise.

BNPL:

In 2019 and 2020, the market was infatuated with BNPL or buy now, pay later. Firms like Klarna (privately held), Afterpay (purchased by Square for $29 billion in 2020) and Affirm (ticker AFRM) were FINTECH darlings. In 2020, PayPal launched its own BNPL offering, and it has been fairly successful. It has made 300 million loans to over 35 million customers in 8 different markets. Last year, PayPal's BNPL offering did $20 billion of payment volume, up +160% year-over-year which places it in 4th place (market share). With the market declines of 2022, these unprofitable businesses materially pulled back.

Now, investors are understandingly questioning PayPal's rationale for taking on credit risk. One of the many reasons Visa and Mastercard are able to garner their valuations stems from the fact that they are payment networks and processors, not credit sensitive financials. The BNPL business is a credit sensitive business, that experiences cyclical ups and downs. Over the last two quarters, as the credit environment has struggled, PayPal has booked credit losses of $254 million.

We applaud PayPal's decision last June to partner with KKR on the credit portfolio. As a quick reminder, PayPal will continue to underwrite and service BNPL loans in France, Germany, Italy, Spain, and the UK. The main difference is that KKR will own the receivables and take on the underlining credit risk. This converts PayPal back into a payment processor and network and starts to get it out of the cyclical and credit sensitive loan business. With KKR backstopping the loan receivables, PayPal frees up nearly $2 billion on its balance sheet. This allows PayPal to funnel more of its capital towards its buyback. Also, PayPal no longer needs to provision for expected loan losses, like a bank.

Free Cash Flow:

In our opinion, the single most important financial metric (for any company) is free cash flow. Certain companies play games with earnings per share, by excluding the dilutive impact of options. Others back out various items from earnings, to hit Street expectations. Once again, we believe that free cash flow cannot be manipulated, and it represents the best indicator for valuation (in our opinion).

Over the last year, PayPal's management focused on driving free cash flow and didn't execute any un-necessary and complicated deals. The balance sheet has $9.9 billion of cash and $4.5 billion of investments versus $10.5 billion of debt. We like the current balance sheet, as it is essentially unlevered and capable of flexibility.

Since its July 2015 spinout from eBay, PayPal has generated $29 billion of free cash flow. 45% of its free cash flow or $13 billion has gone towards acquisitions, while $19 billion has been allocated to re-purchasing its stock. We think that PayPal management will continue to utilize its sizeable free cash flow to repurchase a significant amount of its own stock.

In the 2nd quarter of 2023, PayPal bought back $1.5 billion of stock, or 22 million shares for $68.89 per share. Since the end of 2021, PayPal has retired 6% of its shares. With its $5 billion of free cash flow this year, PayPal is slated to buyback another 3% of its total shares outstanding. Instead of making costly acquisitions, we prefer managements and the Board of Directors decision to buy back its own stock. Not only does it "know this business" remarkably well, but the valuation is quite compelling. With $5 billion of 2023 free cash flow, PayPal is essentially trading at a FCF yield of 8% or roughly 2x the US 12-month Treasury.

If the stock continues to suffer, it might make some sense for the Board of Directors to consider a dividend. While it currently does not pay out a dividend, it might make sense to appeal to true value investors. With its current valuation, PayPal probably appeals more to value investors, than growth investors. Adding a dividend (or possibly a 1x, special dividend), might bring value investors into this company. Just a thought…

Recent Results:

Following 2nd quarter 2023 results, PayPal's stock fell by over (10%). While it exceeded revenue expectations and generated in-line earnings, it continues to struggle with two key metrics. The first concern was the second straight quarter of declining active accounts, which fell by 0.6%. The total number of active accounts at PayPal is 431 million, which is an extremely strong customer base.

A few quarters ago, management "cleaned up" their official number of accounts, by removing some fraudulent accounts and non-active customers. Frankly, we always view account metrics with a "grain of salt" and could probably discount the accuracy of most account bases by 10%. Some investors were disappointed that PayPal management laid out an expectation for 750 million accounts in the future, only to remove that guidance and see the number decline. This is absolutely a fair criticism, but we believe it misses the bigger picture or point.

PayPal is now providing a "clean" account number and it is impressively large at over 431 million (both consumers and merchants). We would rather have a smaller base of active accounts (using the product) than a larger number of questionable or inactive accounts. It is important to breakdown PayPal's accounts into US and non-US customers. As you can see in our pie chart, with continued growth in its international customers, PayPal's account mix is now 55% US and 45% International.

PayPal's customers made 6.1 billion transactions last quarter, which was up +10% year-over-year. We like to look at TPA or transactions per active account, which continues to steadily improve. Last quarter, TPA was 54.7, up +12% year-over-year. We believe this metric shows solid client engagement and it has grown in the low teens for the last 6 quarters.

In addition to their active customer base, PayPal has over 35 million merchants on its platform; 80% of the Top 1,500 internet retailers. Between its customers and business accounts, PayPal has built an impressive payment ecosystem. Even if it isn't going to reach that long-term goal of 750 million active accounts, we are impressed with its sizeable network of engaged customers.

Another important PayPal metric we follow is TPV or total payment volume. During the 2nd quarter, PayPal's TPV was $376.5 billion, up +11% year-over-year. Once again, we like to breakdown this metric into US versus non-US volume. Last quarter, the US TPV was 63% of the total and it grew +9% year-over-year. The International TPV was 37% of the mix, but it grew +14% year-over-year. Just like the outsized growth being experienced in the number of accounts outside the US, we are pleased to see PayPal and its volumes get embraced internationally.

We like to understand per transaction metrics and our starting point is the average payment amount, which was a solid $62 last quarter. We then like to look at margins and understand the profitability PayPal generates per transaction. The first profitability metric is "total take rate", which simply takes total revenue divided by TPV. This was 1.94% last quarter, and it has declined for the last 6 quarters. This clearly isn't positive, but it seems like it is stabilizing. The next metric we analyze is "transactional take rate", which is transaction revenue divided by TPV. In our opinion, this is a cleaner profitability metric, as it just focuses on transaction revenue, not total revenue. Last quarter, this was 1.74%, which was also down for the second consecutive quarter. Looking at it a year ago, it is down a modest 11 basis points, and it should continue to stabilize. Management believes that 2/3rds of this decline is due to foreign currency changes, which seems fairly explainable (due to the strength of the US dollar). The last profitability metric (on a per transaction basis) is something PayPal calls "transaction margin". This is total revenue less transactional expenses and credit losses, divided by total revenue. A year ago, the transaction margin was 48.7% and it continues to decline; last quarter it was 45.9%. None of these transaction-based margins are positive, which should be concerning. If we didn't understand what was causing this pressure, we would "run for the hills". However, our analysis of the payment landscape tells us a very different story.

In its highly competitive online payment business, PayPal's Braintree group competes with privately held Stripe and publicly traded Adyen (ticker ADYN). In terms of reported processing volumes, we believe that Stripe has leading market share, Adyen is #2 and PayPal's Braintree is in third place.

We don't have financial metrics from Stripe, but Adyen just reported 1st half of 2023 results. As a European company, they report semi-annually, not quarterly. Adyen started its business focused on small and mid-sized businesses, but has expanded to larger clients like Uber, McDonald's, and the Gap.

With their recent results, Adyen grew payment volume by +23% and revenue by +23%. While impressive on the surface, this was materially slower growth than it reported in the 1st half of 2022. In comparison, PayPal's Braintree posted +30% revenue growth and +30% payment volume growth, both in-line with a year ago growth levels. On the PayPal conference call, its management team proclaimed that Braintree was experiencing "tremendous momentum" and success.

In the North American market, competition is fierce, and some big businesses are seeking processing cost saves, not additional functionality. The market is highly competitive and there are a few parties fighting for market share. With modest switching costs, it makes some sense for payment gateways to aggressively price your product to win business. It appears that Adyen will remain steadfast on pricing, as it believes that recent competitive practices are unsustainable. PayPal's Commerce Platform is winning, but the environment for margin expansion is temporarily pressured. The margin profile of PayPal's payment platforms - branded versus un-branded - is quite different. As competition heats up, PayPal has decided to set a lower price (at the expense of margin) and gain market share. This aggressive US land-grab strategy can be margin dilutive, but PayPal's management team is assertively expanding its payment volume and scale.

While PayPal is currently absorbing this mix shift pain, we believe some investors are missing the bigger picture. When we analyze payment companies, we love to examine operating margins. Operating margins for PayPal were 21.4% last quarter, up +230 basis points year-over-year. On its conference call, PayPal management reiterated its goal of delivering 100 basis points of operating margins improvement this year. Specifically for the 2nd quarter of 2023, PayPal management guided for 22% operating margins. With actual results being 60 basis points lower, the Street was obviously disappointed. While we understand this issue, it fails to understand how payment platforms operate, when they are at scale.

Payment Companies:

We have covered the payment industry for decades, long before Mastercard's IPO in 2006 and Visa's IPO in 2008. The beauty of the payment business is that they will steal market share from a sleepy giant, every day. That market share donor is cash. We are sure that you are using less and less cash in your daily lives. In fact, cash accounted for only 18% of all US purchase payments in 2022, down 13 percentage points from 2016 (according to the San Francisco Federal Reserve). While the US has lowered its cash usage, 50% of transactions under $10 are still done with cash. Outside of the US, this decline in cash usage has barely started. The numbers show that roughly 75% of global purchase transactions are still done in cash. While some Nordic countries are trying to become cash-less, there are developed countries like Japan and Germany that still are primarily cash based.

Payment businesses are great examples of scale businesses. For example, Visa can process 65,000 transactions *per second* over its network. Each incremental transaction is nearly 100% profit, as the cost to process is essentially already built and paid for. This is why (last quarter) Visa can generate operating margins of 61.8% and Mastercard has operating margins of 58.6%.

PayPal is currently “at scale”, with its global, two-sided payment network. On the consumer side of the equation, it has 430 million active consumer accounts. On the merchant side of the business, it services 35 million businesses. This year, it will handle over $1.4 trillion of volumes, 24 billion of transactions, in over 200 countries. While it may not equate to Visa and Mastercard scale, it is large enough to generate prodigious free cash flow and benefit from its extraordinary size.

Now, we aren’t trying to necessarily compare Visa and Mastercard with a company like PayPal, as they are different. We own all three but understand the differences in their business models. All three companies produce impressive free cash flow and have secularly growing businesses. For perspective, Visa generated $5.5 billion of free cash flow last quarter and that is what PayPal will do all year. However, Visa and Mastercard are at a different stage of growth in their evolution. Last quarter, Visa and Mastercard posted revenue growth in the low-to-mid teens, while PayPal’s was much higher. We believe that the payment networks should produce low double digit top line growth and mid-teens earnings growth for the next several years, but PayPal should grow slightly faster (off of a smaller base). The payment networks should maintain and slightly increase their operating margins (from these already high levels) and use their free cash flow to make selective acquisitions and buy back their stock.

In our opinion, the significantly higher operating margins of Visa and Mastercard are reflected in their much higher valuations. The payment networks deservingly trade at an average of 26x next year’s earnings, which is a premium to the S&P 500. Considering their prospects and higher growth profile, we believe that premium is justified. However, PayPal is receiving none of the love that Visa or Mastercard is receiving. In fact, PayPal isn’t even getting a multiple similar to its peer Adyen or its competitor Square (ticker SQ). Even after Adyen fell by (56%) in August, it still garners a forward P/E multiple of above 30x. Square declined by (31%) in August and has a ton of issues it is wrestling with. Despite this, Square trades at a forward Enterprise Value to EBITDA multiple approaching 20x.

Revenue growth at PayPal will be nearly +8% this year. Analysts are projecting revenue growth of +11% next year, equating to nearly $30 billion. For comparison purposes, the S&P 500 might post 3% growth in sales this year and expectations are looking for 7% in 2024. So, even using lowered expectations, PayPal should deliver 50% higher revenue growth than the overall market.

We never utilize revenue multiples because we feel that they are only employed by companies that cannot produce profitability. We do not believe that revenue multiples fairly assign value, but companies without free cash flow or profits need something to hold onto. Investors using revenue multiples often convince themselves of forward upside by granting an extra one or two or three points of multiple expansion. In our opinion, this ignores profitability. It is nice to have top line growth, but we strongly believe that share price appreciation is driven by free cash flow and earnings growth, not necessarily revenue growth.

As we mentioned earlier, PayPal should generate $5 billion of free cash flow this year. Even if its operating margins stay flat at 22%, PayPal will deliver nearly $5.00 per share in earnings this year (up +20% year-over-year). Looking ahead while still keeping margins flat, PayPal should post $5.75 per share in earnings (up another +15%). In comparison to the market, the S&P 500 should experience a (4%) decline in EPS this year, with sky-high expectations for +17% growth next year (per Zacks Research). For that modest growth, the S&P 500 trades at 21x 2023 and 18x 2024. Once again, when compared to the S&P 500, PayPal's earnings growth is expected to eclipse the market, yet it trades at 10.6x 2024. This is a 40% discount versus the market.

PayPal Conclusion:

Does PayPal have issues? Absolutely! It has made a number of poor acquisitions, it has experienced management turnover, it failed to deliver on its guidance, and it competes in a highly competitive environment. That being said, the outlook for growth is predictable and the valuation puts PayPal in the "deep value" category. As we mentioned earlier, PayPal must address its account declines and it needs to improve and stabilize its margins. However, these issues are reflected in the current stock price. In comparison to the overall market or even payment and FINTECH companies, PayPal is "dirt cheap".

If new management does absolutely nothing but use its free cash flow to buy back its stock, PayPal could go private in a decade. If one assigns a market forward multiple to PayPal, it would be worth over $100 per share, or over 70% higher, but let's not get carried away. While we believe PayPal's strong growth and impressive account base justifies a premium to the market, but there is no need to make herculean assumptions. If one uses conservative estimates (say $5.75 for 2024) and allocates a discounted multiple (say 16x), PayPal is a $92 stock in a year or so (representing 50% of upside). Considering that the market (represented by the S&P 500) is up +15% this year, and the Tech sector (represented by the XLK) is up +36%, there aren't many technology companies trading at this attractive of a multiple. Once again, there isn't a need to put lofty expectations on new management. All it really needs to do is use its impressive free cash flow to repurchase its own stock. If new management is able to grow the account base or improve operating margins, that would be gravy, right?

When it comes to the payments industry, one of our favorite lines is that investing in this space is like "winning by breathing". Each and every day, cash continues to be a market share donor and more and more people are using the internet to purchase goods and services. These are secular growth drivers and provide us the confidence that digital payments are still in the "early innings".

You continue to use less and less cash and continue to purchase more goods online. When you are shopping online, you can't use cash and are likely to use either PayPal or Visa or Mastercard. From our perspective, since we own all three, we are happy with your transactions. The only caveat is that Visa and Mastercard are trading at premiums to the market, while PayPal is on the "discount rack".

In our opinion, it is usually wise to purchase wonderful, free cash flowing payment companies when they trade at these types of attractive valuations. If we are wrong, we would fully expect another company to step in and acquire this global, at scale, two-side payment network.

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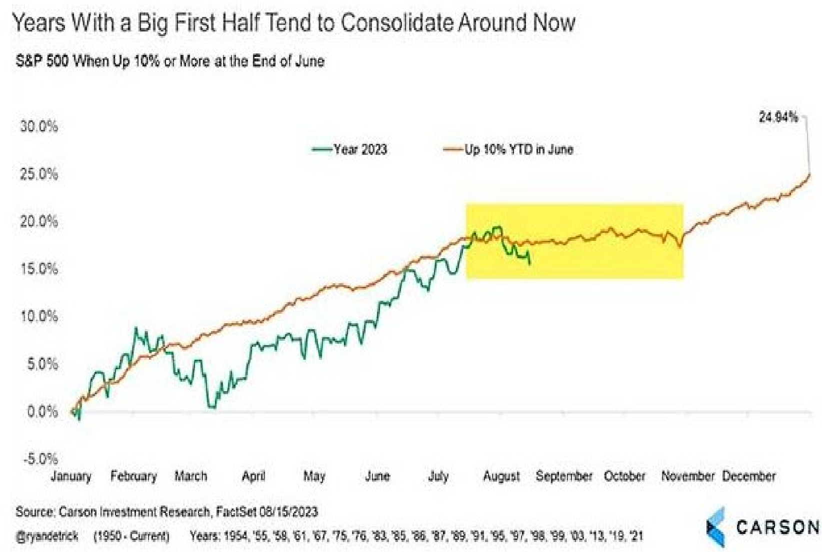
3rd Quarter 2023 Investor Newsletter Conclusion:

As we mentioned in our 1st Half 2023 Reflections (click here), AI or artificial intelligence has taken over. According to AlphaSense, during the 2nd quarter of 2023 earnings calls, 40% of companies in the S&P 500 mentioned AI on their call. Interestingly, only 16% bother to mention AI in their SEC filings. While many companies may claim to be embracing AI, only a handful have made meaningful steps toward incorporating the technology into their operations.

Starting in the 1980s, economic expansions have gotten longer, with the last four averaging 8.6 years in length. Also, recessions have gotten shorter and more event-driven (Dot Com bubble, Financial Crisis and COVID). Since 1945, the length of US economic expansions have averaged more than 60 months or over 5 years. We are currently 40 months into our present expansion and the environment remains resilient. Inflation is declining, without materially impacting the growth of the American economy. The jobs market is robust (with 9.6 million openings), accompanied by solid wage growth. The Fed has stated that a recession is not needed to get inflation back down to its target. Back in 1984 and again in 1994, the Fed successfully raised interest rates without triggering an economic downturn. A big question remains – Is the Fed capable of engineering a soft landing?



So far this year, the S&P 500 is up +18%. As this Carson Investment Research and FactSet chart shows, in years when the market is up +10% or more by June 30th, it tends to take a late summer breather (over 20 different periods). August hasn't been positive, down (2%) and September is typically the worst month of the year for the stock market, averaging returns of (1.1%) since 1928.

We hope you enjoy Labor Day weekend and the rest of your summer. We look forward to speaking with you soon!

Warren Fisher, CFA
Founder & CEO
Manole Capital Management

Cliff Clavin's "Useless Information":

In the 1980s, one of our favorite TV shows was ***Cheers.*** The know-it-all postal worker was named Cliff Clavin and played by actor John Ratzenberger. This recurring segment of our newsletter highlights some "useless" information that Cliff would be proud of.

Debit Cards: In terms of debit cards, China UnionPay recently overtook Visa. According to Nielsen Holdings, China UnionPay now has 40.03% of the world's debit card market versus Visa's 38.78%.

Football: On August 20th, 1920, a small group (including legendary athlete Jim Thorpe), joined together in Canton, Ohio to create the first professional football league, known as the American Professional Football Conference. Later, the league became known as the NFL. On college campuses in the late 1800s, football was a violent intramural game. Now, football has grown into a multi-billion business and America's favorite pastime (passing baseball). In a couple of weeks, the 104th season will begin (Let's Go Dolphins!).

Trading: On August 28, 2000, the NYSE (New York Stock Exchange) began trading in decimals, ending the two-century-old practice of pricing stocks in increments of 1/8th of a dollar. The first stocks to adopt decimal pricing included Anadarko Petroleum and FedEx.

Cars: Five years ago, there were a dozen new cars selling for less than $20,000. According to Cox Automotive, the Mitsubishi Mirage is the only new model going for less than $20,000, with a $19,205 average selling price. Their car pricing guide shows that a middle-of-the-road new car cost over $48,000, up +30% since 2019. The report also shows that it takes over 42 weeks of median US household income to cover the average cost of a new car. Used car prices are also elevated, as the average July price was $27,000, also a +30% hike from 2019. Making matters worse, high-interest auto loans also burden car owners. The average new-car loan costs 9.5% and the average used-car loan just over 13.7%. This helps explain why auto loan delinquencies have been rising this year, despite a strong economy with exceptionally low unemployment. Last quarter, a record 17.1% of new car owners had a monthly payment above $1,000, according to Edmunds.

Food Fights: The last Wednesday of August, in the small town of Buñol, Spain, 20,000 individuals participate in the world's largest food fight - La Tomatina. Trucks will haul more than 100 tons of tomatoes to serve as ammo for this "very red" festival. Nobody seems to know how this tradition began, but the town is eager to keep it going. While the initial cleanup might be messy, the citric acid of the tomatoes leaves Buñol's streets more sparkling than before.

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DISCLAIMER: