



No CASH Accepted
June 2017

Manole Capital Management

Commerce Club at Oxford Exchange

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The Summer 2017:

Maybe you are a macro investor and will closely watch verbage changes in Fed policy decisions. After all, this is the 4th time since December of 2015 that short-term interest rates were raised. Will the Fed deviate from its plans to increase interest rates another two times this year? The best location to gauge market perception remains the [CME Fed Watch tool](#). There seems to be a bond battle brewing, between The Fed and global fixed income markets. With \$9.5 trillion of negative yielding securities, there continues to be a large gap between US rates and certain international markets. Along the US yield curve, rates are narrowing with a flattening of 2-year and 10-year spreads. With a balance sheet in-excess of \$4.5 trillion (versus \$800 billion pre-Financial Crisis), we expect additional volatility once The Fed decides how it will begin the mechanism unloading some of its bond holdings. As of today, lifting US interest rates have yet to truly impact financial markets, as indices continue to hit all-time records.

Maybe you are more fascinated with geopolitical issues, like the recent elections in France and England. Maybe you focus your attention on the energy sector and watch the rising and falling of oil prices. Comments from OPEC and tensions in the Middle East continue to impact and swing crude prices. Closer to home, maybe the investigations into Trump interest you. How did the Russians tamper with the Presidential election and did it impact results? What will happen if the debt ceiling isn't lifted? Uncertainty persists with the fate of healthcare reform. What will happen with that growth-boosting tax overhaul? Just maybe you are wondering how Puerto Rico's decision to pursue statehood will be settled. Wouldn't adding a 51st star to all our flags be a "huge" boost to US flag manufacturers?

Puerto Rico:

Less than 1 in 4 Puerto Ricans participated in its nonbinding referendum last week, but statehood drew the support of 97% of voters. In prior votes (in 1967, 1993, 1998 and 2012), statehood had never actually won an outright majority. While Puerto Rico has been a US territory for over 100 years, its debt crisis, bankruptcy proceedings and outstanding debt of \$125 billion highlights another interesting point.

Illicit economic activity, such as black market or undeclared transactions, is called "shadow economics." The Top 3 shadow economies, as a percentage of 2017 Gross Domestic Product (GDP) are Greece at 21.5%, Italy at 19.8% and France at 12.8%. Economists estimate the shadow economy of Puerto Rico far surpasses these at an astounding 30% of its GDP! This equates to \$21 billion of goods and services produced "off the books". Simply stated, underground activity and tax avoidance deprive a government of significant income. Besides suffering the negative effects of high unemployment at 11% and 45% of its population living below the poverty level, Puerto Rico erred in setting its sales tax at 11.5%. This wasn't always the case, as sales tax was increased from only 7% a couple of years ago. Increasing the sales tax had an unintended consequence of lowering governmental income because merchants and consumers now actively look to bypass card or check transactions, for the anonymity of cash usage.

Cash Has a Cost:

In several developed economies, we see the exact opposite of this trend. Consumers frequently use credit cards to generate airline points or cash-back rewards. The simplicity of using cards not only quickens transaction speeds, but also offers numerous other benefits for merchants. Many restaurants have decided to stop accepting cash and nearly all airlines no longer accept paper money for in-flight purchases of food and beverages. One Tampa merchant has the following sign posted outside its establishment:



When we questioned the owner about why the business moved to 100% electronic transactions, she said it simply was for “safety” reasons. “Safety” can refer to cleanliness and is a main reason cited for restaurants making the switch. We apologize in advance for the following fact, but paper currency can carry more germs than a household toilet. Viruses, bacteria and the flu can live on money for 17 days. Think about that the next time you pay for your food and don’t wash your hands before eating.

Of course, “safety” also includes not having cash available to be stolen. Any merchant that has cash is taking a risk of theft from employees or robbery from others. Cash needs to be transported from a store to a safe environment, like a bank. The expense of moving, storing and transporting money can be costly, with armored car pick-up’s running \$2,000/day. In addition, a Harvard Business Review study indicated that the US spends \$200 billion annually just to keep cash in circulation. The US Mint reported that its production cost to make a penny and nickel were \$0.015 and \$0.08 respectively. With the government putting nearly 5 billion pennies into circulation each year, should the use of these costly coins be questioned?

Secular Growth:

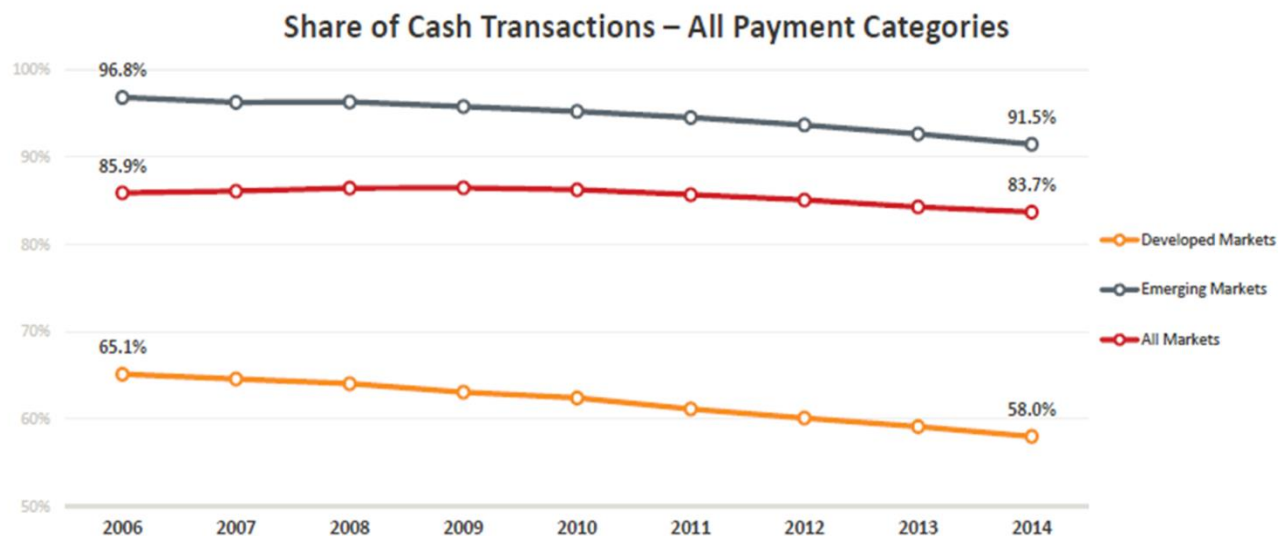
We have identified 5 key drivers for electronic payment growth. The combination of these factors provides us with confidence in the future growth of electronic payments.

1. Growing Displacement of Cash & Check
2. The Proliferation of eCommerce
3. Inability of Banks to Serve All
4. Increase in Merchant Acceptance
5. Availability of New Channels

#1) Displacement of Cash:

Many are surprised that all developed economies are still widely dependent upon cash transactions.

Secular Growth Opportunity Remains High



Source: OECD definitions, BIS statistics, McKinsey global payment data, Euromonitor and Mastercard Advisors analysis

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As the MasterCard chart above shows, nearly 84% global transactions in 2014 were still conducted in cash. While this is declining, the pace is somewhat slow. A decade ago, this percentage was 85.9%, only about a 2% change. There are drastic differences between developed markets (at 58% cash) versus emerging markets (at 91.5%), but the long-term trend is crystal clear to us: Cash usage will slowly and surely decline for years to come.

The Cashless Society:

Sweden is a wonderful example of a country striving to become a cashless society. According to its central bank, the Riksbank, cash transactions made up ~ 2% of the value of all payments made in Sweden last year. It is estimating that cash usage will fall to 0.5% by 2020. According to a recent Visa study, Swedes are 3 times more likely to use a card for payment than the average European. On average, each Swedish card-carrying individual makes 207 payments per card annually. Public transportation (like buses, rail and metro) no longer accept cash. 900 of Sweden's 1,600 bank branches no longer keep cash on hand, nor do they accept cash deposits. ATMs have become scarce. Not only do merchants prefer card and phone payments, but even churches regularly accept electronic payments.

#2) eCommerce:

Possibly the most obvious catalyst for electronic payments is the trend of increased online shopping, where transactions only can be conducted with cards or through electronic intermediaries like PayPal. eCommerce is estimated to be roughly 8% of the \$4.9 trillion of US retail sales. This number should continue to creep higher, especially with Amazon's entry into new product categories (i.e. its acquisition of Whole Foods last week). These purchase transactions will boost the secular growth of electronic payments for years to come.

#3) Underserved by Banks:

It is estimated that 2.5 billion people are underserved by banks. Even in our modern society, it is believed that 1 out of 13 US households are un-banked. Out of the numerous reasons for not using a bank, a US Federal Reserve study of non-users highlighted a few key finds: 25% did not have enough money to open an account, 10% had a bad credit history and 2% couldn't afford the banking fees.

#4) Increased Merchant Acceptance:

One of the many merchant arguments against cards is the high cost associated with acceptance. However, more and more merchants adopt card and mobile payments to boost sales. iZettle is a cheap and easy payment application that allows micro and small businesses to accept card payments. Using their phones as card readers, some merchants have seen sales increase by 30% after they made the change. We love the diversity of food trucks and mostly all now accept card payments. If you plan on enjoying an art or street fair this summer, most sellers will be more than happy to swipe your card. Not only have most vending machines migrated to card acceptance, but so has our daily commute. Most toll roads have replaced collectors with automatic, card-based readers. Going back a few years, all taxi cabs only accepted cash. Now, not only are Uber and Lyft cashless, but taxis have converted their payments to card-based systems. Passengers and commuters love the security and simplicity of card payments. Remember those Swedish churches we mentioned earlier? Well, some are now displaying their phone numbers at the end of a service. Instead of passing a plate, members can virtually donate to their traditional Sunday collection.

#5) New Channels:

Quite possibly the most surprising, but wildly successful example of embracing a new channel for electronic payments is Kenya's M-Pesa platform. The M stands for "mobile" while *pesa* is Swahili for "money". M-Pesa is a mobile, phone-based money transfer platform that was launched by Vodafone in 2007. It allows mobile phone users to easily deposit, withdraw and transfer money and pay for goods and services. This service bypasses traditional banks and allows users to put money into an account stored on their cell phones. If a user wishes to transact, he/she simply texts a secure PIN (personal identification number). Users are charged a small fee for sending and withdrawing money, but it is 100% bank-free. When an individual needs to load funds or withdraw money from their account, a wide network of physical locations and agents is available. These are modern-day bank branches with airtime resellers acting as bank tellers. Not only has this system been credited with bringing financial services to millions of people in the developing world, but it is also credited with reducing crime in otherwise largely cash-based societies.

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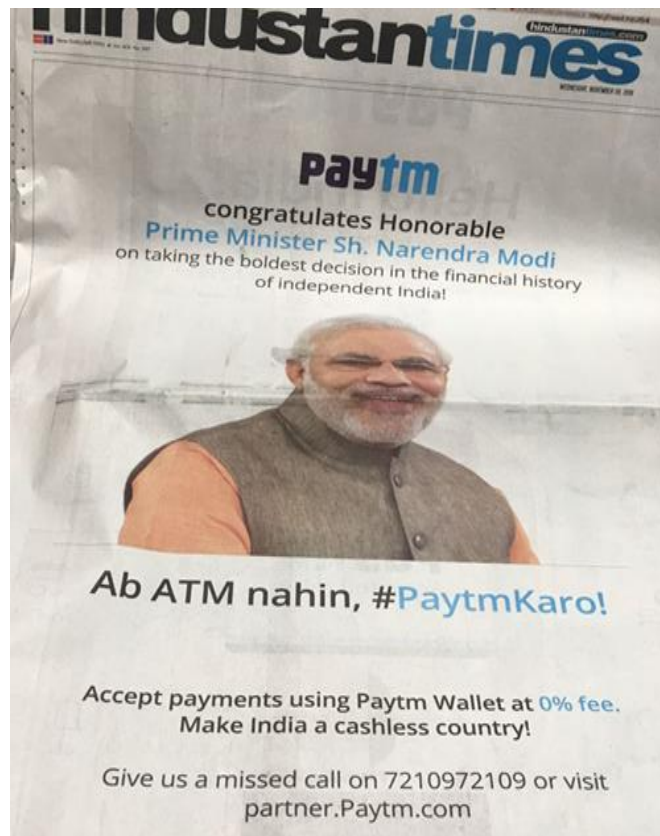
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Another Example – India:

Nearly 4 years ago, India began an innovative process. Instead of providing governmental benefits directly to people in cash, it began to transfer funds into recipients' bank accounts. This program, called Direct Benefit Transfer or DBT, was the start of a digital revolution. Once personal, unique identification numbers were widely employed, India replaced its traditional cash transfer scheme. One of the biggest problems with this system is India's lack of a strong banking infrastructure. It has only 10.5 bank branches for every 100,000 adults, and many struggle to travel the miles necessary to reach a bank to withdraw funds or make payments. Cell phones provided the answer.

It was recently reported that India has surpassed the US in number of smartphones. There are issues with India's power, electricity and poor network connectivity, but mobile phone usage has clearly been on the rise. With more of these devices available, it was only a matter of time before mobile payments in India exploded. Then India's Prime Minister – Narendra Modi – made an aggressive monetary decision in November of 2016. He declared that existing 500 and 1,000 paper money notes would become invalid. This was clearly an attempt to shine light on the country's shadow economy and force Indians to finally pay sales tax. The ensuing chaos forced everyday citizens to reconsider how they transact for goods and services.



Paytm:

Enter Paytm, the acronym for "pay through mobile." Paytm paid for this full-page ad, in The Hindustan Times, thanking Prime Minister for "taking the boldest decision in the financial history of independent India." Following the government's crackdown on paper money (and corruption), the leading Indian mobile wallet Paytm saw a huge surge in growth and transactions. Paytm allows users to use their cellphones to make transactions at over 1 million locations across India's 1,200 cities. India is quickly migrating from a physical to a digital economy.



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Conclusion:

We look to keep our investing philosophy simple. We strive to “un-complicate the complicated.” To understand the details of how a card transaction works, you can visit our website at www.manolecapital.com or read our article by clicking [here](#). It explains the authorization, clearing and settlement of funds for card transactions and who gets paid for what in the process. If you are interested in the future of mobile payments or a deep dive into our thoughts on PayPal, feel free to click [here](#).

Our belief is that electronic payments are a wonderful, long-term growth opportunity. Cash will likely be in existence for years to come, but its use is experiencing a slow and steady decline. Some older generations fear advances in technology or worry about electronic fraud. But there is no doubt that mobile phones and cards will continue to steal market share from cash. As smartphones become more prevalent, more and more purchase transactions will become electronic. With the advent of easy-to-use, person-to-person apps, cash usage should continue to decline. We continue to be attracted to these types of secular growth opportunities, that benefit investors regardless of which way volatile cyclical markets turn.

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