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MasterCard: Looking offshore for growth

Summary:

The prize is big – 85% of the global payment market is still cheques and cash, with only 15% of payments done with credit cards. The shift to plastic has a long runway. This is why we see MasterCard, the payment network, as a true growth company. Is this fully justified, or, could it be possible that the market is actually underestimating the growth ahead? In recent years, MasterCard has combined volume growth in payments, price increases and, more recently, tax cuts, to beat all forecasts. Going forward, volume growth in payments will be the main driver, in our view, possibly boosted by new markets like China, and mobile payments, which could become the new high-growth element.

MasterCard's market cap is up c. 20% over the past year. This reflects good earnings growth; the market's love of growth companies in a low-growth world and, probably, the recent news that China's domestic payments market (which currently only has China Union Pay) will open up in the next 18 months. At the same time, we highlight that the strong dollar is negative for MasterCard.

To understand MasterCard, it helps to know how it differs from Visa (the other major payment network) and American Express (Amex, the "card" bank). First, MasterCard is a far more global company than the other two with only 39% of its net revenues coming from the US (Visa stands at 54%, and Amex at 72%). Second, MasterCard and Visa are not financial companies like Amex. They only provide a network (sometimes referred as "rails") for payments to be made, while Amex not only has a payment network but is also a bank (for cards) and is therefore exposed to some credit risk.

What makes MasterCard and Visa so unusual is that they were both once owned by groups of banks before demutualising and listing on US stock markets in 2006 and 2008, respectively. Clearly it is very difficult for other companies to replicate what MasterCard and Visa have done. Here we note that Visa Europe is the exception, having split from Visa Inc in 2007 (prior to Visa Inc's listing), it is still owned by European banks. There is also talk that Visa Europe may demutualise in the near future. Visa Europe has a perpetual put option to Visa Inc.

Earnings forecast and the company's long-term goals:

MasterCard currently has 3-year targets that were set in 2012 (and these will be updated later this year):

- 11%-14% revenue growth;
- at least a 20% EPS compound annual growth rate; and
- an operating margin >50%.

These are strong growth numbers for a fairly large company (with a profit of $3.6bn in FY14). We therefore believe the company's revenue target will not be met in 2015 because of the strong dollar, and neither, in our view, will the EPS target (consensus expects a 12% YoY rise in FY15). We view the Group's operating margin target as achievable, while we note that all these three-year targets are expected to be achieved in FY16.

The long-term drivers of the business ensure good underlying volume growth in payments. In recent years (since listing), this was combined with price increases (*refer to charts below*), and more recently a lower tax rate, giving a strong boost to earnings. Going forward it seems to us that price increases will be less likely in many of its markets (e.g. price cuts looming in Europe). This means MasterCard will have to rely on volume growth to drive revenues.

Global Ideas is a newsletter published three times a week (Monday, Wednesday and Friday) and available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watchlist, which is continually reviewed and updated.

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Over the medium term this volume could be boosted materially by mobile payments. The early signs here are very encouraging. For example, near field communication (NFC) like Apple Pay, seems to stimulate payments as consumers find it very convenient. In Europe, NFC-related volume growth could more than counter the effects of lower interchange prices.

Valuation and recommendation:

The discounted cash flow (DCF) value for MasterCard is $120/share. This is c. 30% above the current share price. The P/E multiple to December 2015 is 27x, and 22.4x to December 2016. The ROE, in 2014, was 51%. This is a hugely profitable business model with enormous barriers to entry. The key for further share-price performance, in our view, is likely to be continued solid revenue growth. We believe that operating margins and ROE can't be expected to rise much further.

Unfortunately the share doesn't offer enough upside at the moment. This is clearly a business you want to own at some stage but we need to be patient on the pricing. We would recommend buying the shares at $80-$85/share - wait to buy at lower prices.

Anchor Capital – our investments in offshore financial companies:

Banks make money in three ways – fees to make *payments*, making a margin on *lending*, and a range of *other fees* for overdrafts, investments etc. At Anchor Capital we have recommended investing in various financial companies that rely to varying degrees on these three areas – US Bancorp is bigger in *payments* than most banks; Wells Fargo is bigger in *lending*; JP Morgan, being a universal bank, is bigger in the *other fees* category; Amex is mostly a *payments* bank; and UBS is huge in *other fees*, such as wealth management etc.

Lending is currently under pressure in most global markets because of modest loan growth and very low interest rates depressing net interest margins. This is a headwind particularly for Wells Fargo, and US Bancorp. Hikes in interest rates could help. *Payments* continue to be a strong area because of the structural advantages to the industry and the continued swing from cash/cheques to plastic, although conditions are particularly competitive in a sub-segment known as co-branded cards (impact on Amex). *Other fees* are really helping JP Morgan and UBS, companies that we like. We note though that more work is required on the outlook for digital payments and thus for the impact on Amex, MasterCard as well as PayPal.

A positive for MasterCard is that the company is gaining market share in debit cards globally (i.e. the US and the rest of the World) and in credit cards outside of the US (although we note that it is losing market share in the US).

Closed vs open card schemes

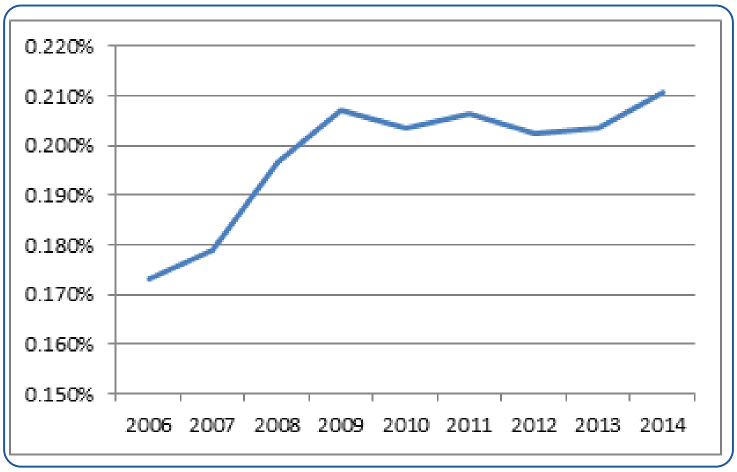
American Express is a closed loop card scheme , like Discover Card (also listed in the US). Closed loop schemes are also known as three-party schemes because the ISSUER (e.g. Amex) in the transaction (i.e. the cardholder's financial institution) is the same as the ACQUIRER (Merchant's financial institution).

Closed loop schemes differ from open card schemes like Visa and MasterCard as well as RuPay (in India) and UnionPay (in China) which are four-party schemes. Here the ISSUER (say the cardholder's bank e.g. Chase) is different to the ACQUIRER (the merchant's bank e.g. US Bancorp).

As per the 2014 MasterCard annual report, in a typical four-party transaction, "a cardholder (or an account holder who may not be using a physical card) purchases goods or services from a merchant using a card or other payment device. After the transaction is authorised by the Issuer, the Issuer pays the Acquirer an amount equal to the value of the transaction, minus the interchange fee and then posts the transaction to the cardholder's account. The acquirer pays the amount of the purchase, net of a discount (referred to as the 'merchant discount' rate), to the merchant. The merchant discount rate, among other things, takes into consideration the amount of the interchange fee."

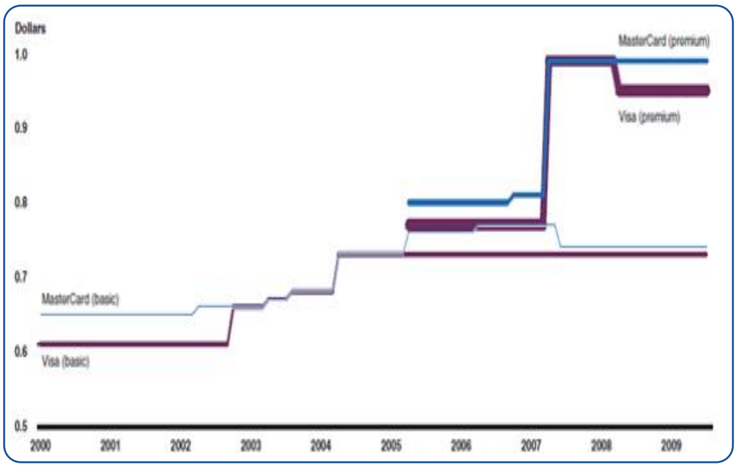
Company data:

<u>Net Rev($)/GDV($) - MasterCard's take:</u>



Source: Company data, Anchor Capital

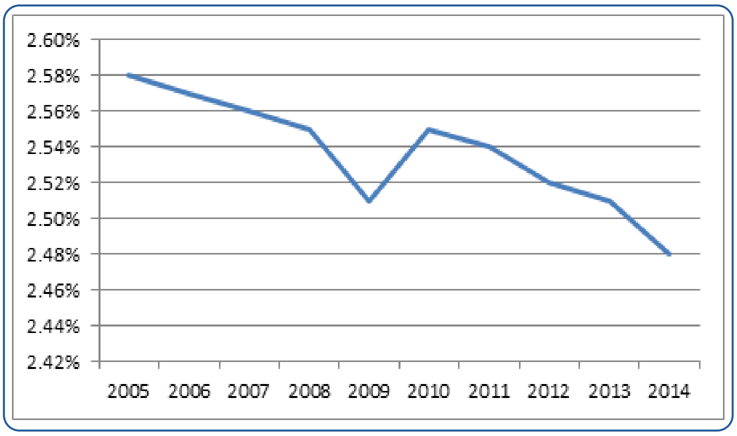
<u>Changes in interbank fee costs (2000-2009):</u>



Source: Company data, Anchor Capital

The graph above of interchange fees shows how these rates have increased from 2006 to 2009 – post the IPO of MasterCard in 2006. Price increases now seem unlikely in many developed markets. If anything prices may come under pressure as a result of regulation. The “yield” will drop in Europe, when interchange fees decline next year. It also appears that MasterCard and Visa fees are extremely resilient and that other players in the payments chain are more likely to feel the pain, if interchange rates decline. This is the experience of prior regulatory changes.

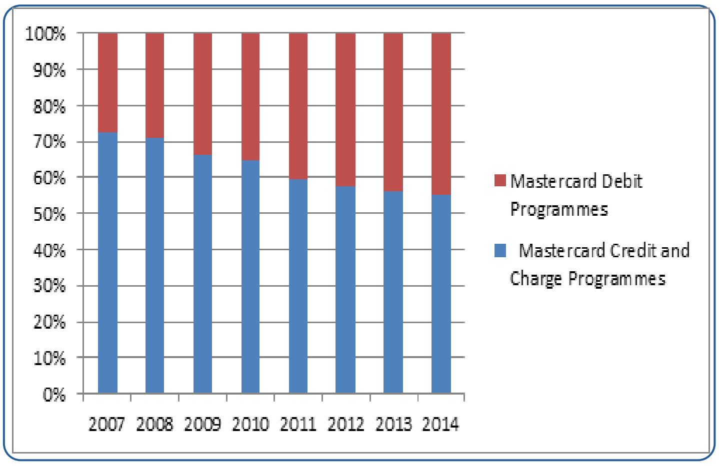
Average discount rate at American Express:



Source: Company data, Anchor Capital

By comparison, the discount rate for Amex (the cost that the merchant incurs for accepting an Amex card) as shown in the chart above has been trending down and we believe it will continue to do so.

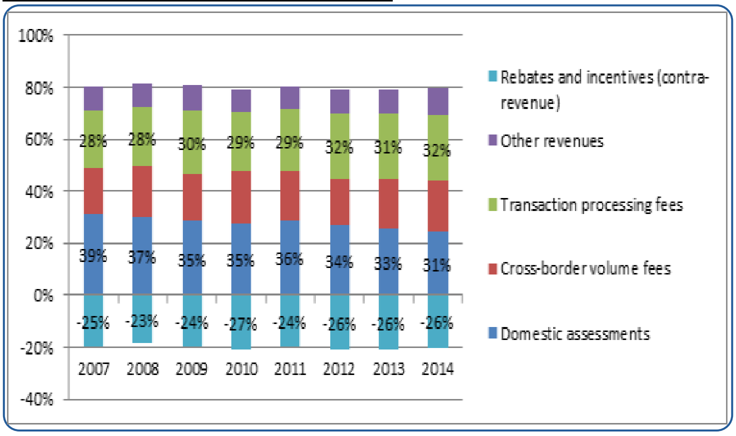
MasterCard split of gross dollar volume (GDV i.e. total spend) by card type:



Source: Company data, Anchor Capital

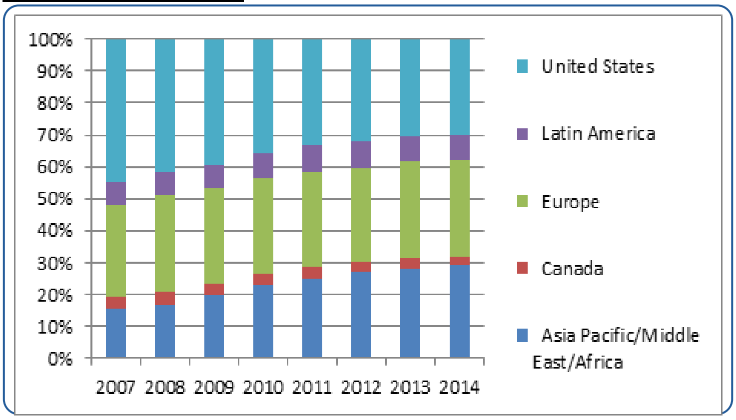
At the same time we have also seen debit cards growing in importance for MasterCard, although these still account for <50% of GDV.

MasterCard net revenues split:



Source: Company data, Anchor Capital

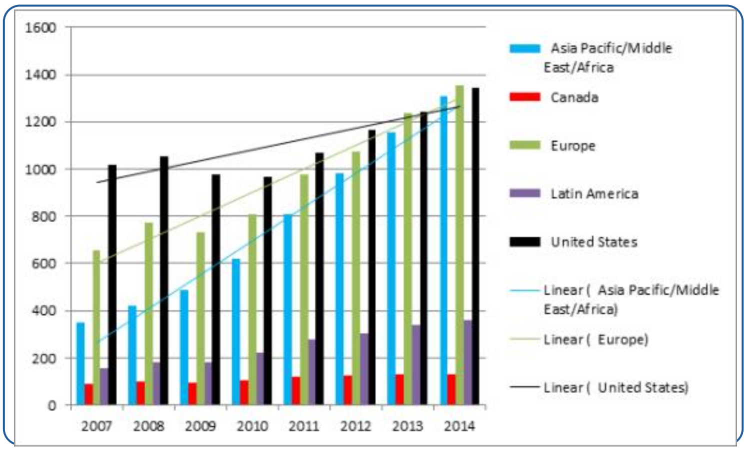
GDV split by region for all MasterCard credit, charge and debit programmes:



Source: Company data, Anchor Capital

The chart above shows how AsiaPac/ MEA has grown to an almost equal share with Europe and the US. This region’s prospects have recently been boosted by the news that the Chinese domestic payments market (up to now only cross-border trade was accessible) will open up to Visa and MasterCard by (possibly) late 2016. The GDV/region ($bn) is shown in more detail in the chart below. The US has been a slow grower for MasterCard since 2007 because of the decline in their credit card GDV post-2008 (2014 credit card GDV is still below 2007 – they have also lost market share in the US), while MasterCard’s US debit card spend has grown strongly, gaining market share in recent years, to now exceed the credit/charge card spend.

GDV per region:



Source: Company data, Anchor Capital

The industry:

According to a *MasterCard Advisors* analysis the scope for MasterCard to grow its card payments in Europe, especially in Germany, is enormous. This will be further boosted by the coming European cuts in debit (to a 20-bpt cap) and credit card (to a 30-bpt cap) interchange fees. Merchants will then be more inclined to accept cards as means of payment.

<u>Share of purchase volumes for US credit card issuers, 2014:</u>

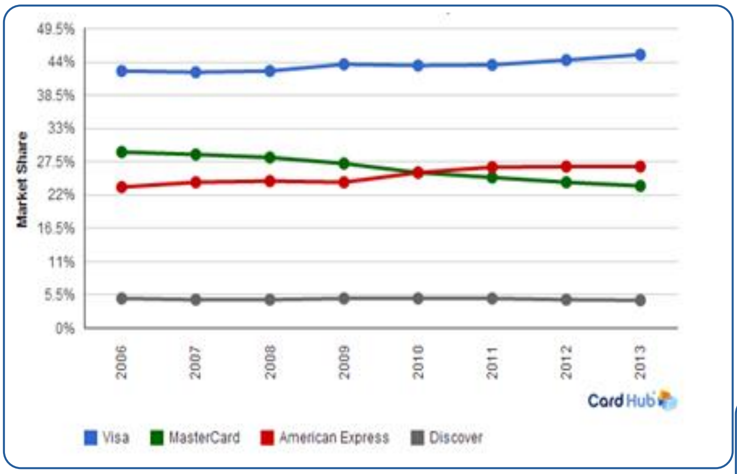
Market shares of the 10 largest U.S. credit card issuers are shown based on purchase volume (spending at merchants) for 2014.

1. American Express
25.1%
2. Chase
19.4%
3. The Rest
12.8%
4. BofA
10.7%
5. Citi
8.3%

Source: Nilson report

While MasterCard does little business with Chase. It has, however, recently signed a 10-year deal with Citi.

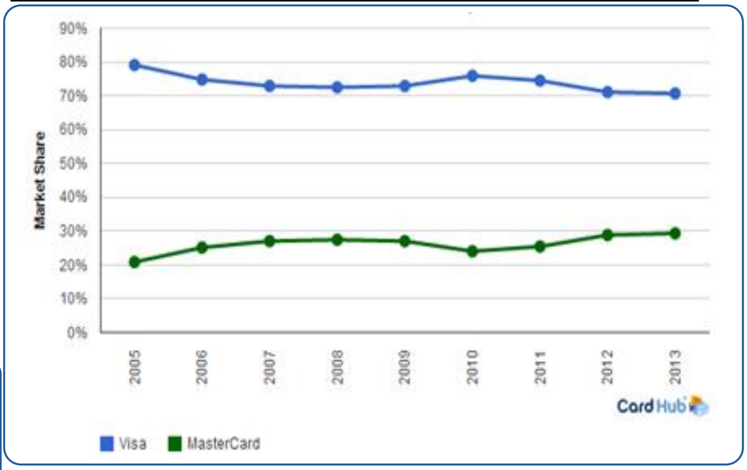
<u>Credit card market share by network purchase volume:</u>



Source: Cardhub

MasterCard plays second fiddle to Visa in terms of credit cards in the US. The company has also been losing market share (for several years now), to both Visa and Amex. In debit cards, MasterCard is also much smaller than Visa but, in recent years, it has been gaining market share at the expense of Visa.

<u>Debit card market share by network purchase volume:</u>



Source: Cardhub

MasterCard currently generates 61% of its revenues outside of the US vs Visa which is bigger in the US. We note that MasterCard purchase transactions are also growing stronger outside of the US, hence the slightly stronger growth (of 13.6% according to the *Nilson Report*) from MasterCard in 2014.

The Nilson Report also forecasts that Asia Pacific will be the fastest-growing market in terms of purchase transaction over the next decade, followed by Mideast/Africa. These two regions represent 29% of MasterCard's total spend (GDV).

Consistent with our earlier comments , MasterCard has clearly gained share in US debit card spending, but it has also lost market share in US credit cards particularly over the past 7 years. During this long period, Amex has been the star performer (in terms of both credit and charge cards) according to the *Nilson Report*. So to sum up, first, debit cards have grown stronger than credit cards in the US and, second, debit-card spend is not too far from credit-card spend in the US.

The chart below from *The Economist* shows just how competitive the US credit-card market has become. Card companies are having to provide very juicy offers in order to get the attention of new customers.

<u>Offers on new credit cards, average:</u>

Source: The Economist, Evolution Finance
*On debts transferred to a new card

We also highlight the following points:

- US consumers have been conservative in their use of credit card debt since the global financial crisis, and it shows in the country's very low delinquency levels. Delinquencies are thus only likely to increase from this level, in our opinion.
- According to the *IMF* and *McKinsey*, US households have also made solid progress in reducing debt levels, along with the financial institutions that serve them. This makes for a far more stable debt environment than many other Organisation for Economic Co-operation and Development (OECD) countries.
- The *BIS, IMF* and *McKinsey* also note that US consumers have got their household debt levels down to manageable levels. US debt servicing costs are now amongst the lowest of all major economies.
- Cheques continue to lose ground to debit cards and, since 2010, to credit cards. This bodes well for MasterCard, with 29% of global card spend coming from Asia Pacific/ME and Africa - regions where MasterCard has a strong market share.

David Gibb

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