

PayPal Holdings, Inc.

Capitalization Summary (\$MM)

Price	\$39.55
Diluted Shares (MM)	1,214
Market Cap	\$48,014
Total Debt	Nil
Cash & Investments	(\$6,427)
Enterprise Value	\$41,587

Share Ownership and Trading Data

Average Daily Trading Volume (MM)	8.4
52-Week Price Range	\$44.51-\$30.52
Short % of Float	1.8%
Major Shareholders	Pierre Omidyar 6.8%



Valuation and Misc. Stats (\$MM) 9/30/16

Book Value	\$14,192
Price/Book Value	3.4x
EPS (ttm)	\$1.13
Price/Earnings	35x
EBITDA (ttm)	\$2,235
EV/EBITDA	18.6x
Dividend Rate/Yield	NA

P&L Analysis (\$MM)

Fiscal Year Ending December 31,	2013	2014	2015
Revenues	\$5,636	\$6,757	\$9,248
Operating Income	\$1,091	\$1,268	\$1,461
Margin	16.2%	15.8%	15.8%
EBITDA	\$1,544	\$1,784	\$2,117
Margin	23.0%	22.3%	22.9%

Catalysts/Highlights

- Recent Visa, MasterCard agreements should accelerate revenue growth
- Triple-digit growth at Braintree/Venmo plus retail and credit penetration provide upside to revenue forecasts
- \$6.4B of cash and investments, repatriation tax holiday could lead to outsized capital deployment in 2017

INVESTMENT RATIONALE

Spun off from eBay in July 2015, PayPal (PYPL) is the leading end-to-end digital payments service provider, processing over \$300 billion in annual total payment volume (TPV). PYPL shares have modestly outperformed since last year's *Forgotten Forty*, increasing by 13%. But shares are 11% off recent highs, and 2016 has been a volatile, event-filled year for PYPL shareholders.

Most prominently, PYPL's efforts to renegotiate the terms of its relationships with card payment networks became heated. In May 2016, Visa's CEO threatened to compete with PYPL "in ways that people have never seen before" if the two companies could not find a way to work more cooperatively. PYPL ultimately reached a transformative partnership agreement with Visa. Announced in conjunction with PYPL's 2Q16 earnings release in July 2016, the new Visa agreement supports greater consumer payment method choice and ends "steering" practices that encouraged users toward low-cost (for PYPL) ACH funding sources over debit and credit cards. In exchange, PYPL will receive "greater long-term certainty on fees paid to Visa," including volume-based incentives (fee discounts) from Visa and access to its retail tokenization services, which enable contactless in-store payment. PYPL should benefit from incremental transaction volume growth, as consumers are no longer deterred from using their preferred payment method. PYPL did not reaffirm its medium-term guidance for ~15% annual revenue growth at the time of the announcement, and management was guarded about the implications of the deal, which spooked investors and sent shares down 7%.

It appears at least some of management's reticence was due to then-ongoing negotiations with MasterCard (MA), and subsequent announcements/management commentary have helped increase our confidence that these agreements will be net positives for PYPL over the medium and long terms. In September 2016, PYPL announced an agreement with MasterCard featuring non-steering and volume incentive terms similar to the Visa partnership. Additional benefits for PYPL from the deals include elimination of mobile wallet fees and enablement of instant transfer of PYPL balances to V/MA debit cards. On October 20, 2016, PYPL released 3Q16 results that were largely in line with expectations but provided rosy 2017 and medium-term outlooks, which helped cool investor concerns over the recent agreements. PYPL expects revenue to grow 16%-17% in 2017, with roughly flat operating margins, while PYPL upgraded its 3-year revenue growth rate outlook to 16%-17% and, importantly, confirmed its expectations for stable to growing adjusted operating margins over that time frame. PYPL shares rebounded by 10% to above \$44 upon the announcement. In subsequent investor conferences, PYPL provided additional clarity on the new payment network relationships. Based on testing, PYPL is confident that the incremental volume gained by increased user engagement will outweigh higher funding costs. Much of the shift from ACH will be to debit, which is still a relatively low-cost funding option. PayPal CFO John Rainey also noted in November 2016 that while it is still very early in the transition, the transaction margin headwind had been slightly less than PYPL modeled.

More recently, PYPL shares have declined 5% in the wake of Donald Trump's election victory and are now 11% below the post-3Q16 announcement levels. Some of the recent decline may reflect broader technology sector underperformance post-election and renewed headwinds from the strengthening U.S. dollar, but PYPL has also been subject to unique concerns over the potential repeal of the Dodd Frank Act's Durbin Amendment under the next administration. The Durbin Amendment limits interchange fees charged on debit card transactions. We believe the market has overreacted to this risk as it has to many prior perceived PYPL risks (e.g., V/MA relationships, Apple Pay, Google Pay, credit risk, etc.). For one, there is no guarantee that the Trump administration will target the Durbin Amendment. This action would require congressional support, and although House Financial Services Committee Chairman Jeb Hensarling has supported such legislation, the Durbin Amendment is forcefully backed by the retail industry lobby and is generally perceived as pro-consumer. In any case, it is highly likely that PYPL already locked in favorable debit interchange rates as part of its V/MA agreements, and it should remain in a strong position in future negotiations.

After the recent declines, PYPL shares trade at ~16x 2017E EV/EBITDA or 20x 2017E adjusted EPS after backing out the Company's \$6.4B cash hoard (at 80% to factor in potential repatriation taxes and capital needs). We believe this represents a bargain valuation considering PYPL's unique position to capitalize on secularly-growing global digital transaction volume. PYPL's impressive revenue growth rate is combined with its business model's inherent operating leverage. By comparison, Visa trades at ~24x 2017E P/E despite underlying earnings growth rates slightly lower than those of PYPL. In our base case valuation, we conservatively project EBITDA margins to decline ~100 bps and PYPL's EBITDA multiple contracts to 15x by 2019. This implies a 3-year forward-looking intrinsic value estimate of approximately \$55 per share, which translates to only ~13x 2019E free cash flow net of cash on the balance sheet. Looking to potential catalysts in 2017, another year of strong financial results should ease concerns over PYPL's competitive position, the V/MA deals, and Durbin risks. A repatriation tax holiday could be another catalyst for PYPL shares, as \$5.1 billion (~11% of the market cap) of its cash hoard is overseas. PYPL spent \$945 million to repurchase 24 million shares YTD 3Q16 and has plenty of spare capacity between the cash and annual CFF approaching ~\$2.5 billion in 2017. Longer term, we view Venmo's monetization as essentially a free call option. Venmo is extremely popular with millennials, generating \$4.9 billion in TPV in 3Q16 alone on 132% Y/Y growth. The Company is currently testing initial in-store payment and other monetization schemes for Venmo.