PayPal Holdings

Information Technology
NASDAQ: PYPL
Market Perform | No Action

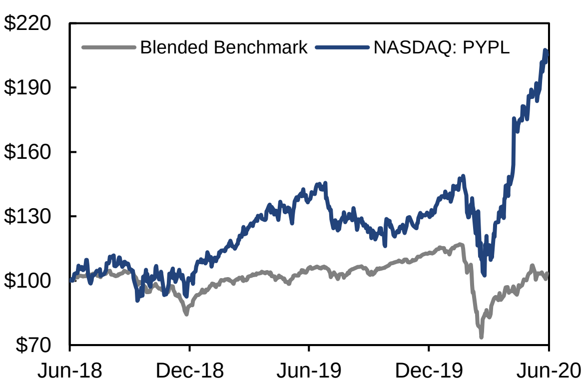
June 30, 2020
Helena Cherniak-Kennedy, Portfolio Manager
Katie Tu, Investment Analyst

Return on Investment	
Current Share Price	$174.23
Target Price	$191.00
Dividend Yield	0.00%
Holding Period Return	10%
Conviction Rating	N/A

Market Profile	
52-Week Range	$85.26 - $174.23
Market Capitalization (US$mm)	$204,574
Net Debt (US$mm)	($2,219)
Minority Interest (US$mm)	$44
Enterprise Value (US$mm)	$202,399
Beta (5-Year Monthly)	1.19

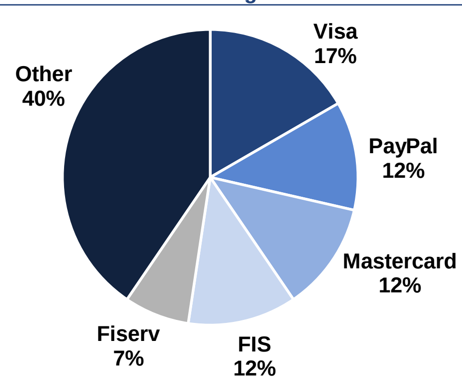
Metrics	**2020E**	**2021E**	**2022E**
Revenue (US$mm)	$20,451	$23,513	$26,994
EBITDA (US$mm)	$5,032	$6,134	$7,033
Total Debt/LTM EBITDA	1.13x	1.15x	1.15x
EV/EBITDA	40.2x	33.0x	28.8x

Historical Trading Performance (Indexed to $100)



Source: S&P Capital IQ

Figure 1: Credit Card Processing Market Share



Source: CFRA

Business Description

PayPal Holdings Inc. (NASDAQ: PYPL) is a leading digital payment solutions platform with a global two-sided network connecting consumers and merchants. PYPL's core proprietary Payments Platform includes: PayPal, PayPal Credit, Braintree, Venmo, Xoom, and iZettle. PYPL was incorporated in 2015 following its spin-off from eBay (NASDAQ: EBAY).

For consumers, PYPL offers: (1) digital wallets to facilitate secure digital and mobile payments to merchants through PayPal, Venmo, and PayPal Credit; (2) person-to-person (P2P) payment solutions through PayPal, Venmo, and Xoom; and (3) consumer credit products through PayPal Credit.

For merchants, PYPL facilitates simple, secure digital checkout solutions online, on mobile, and in-store with a technology-agnostic model that functions across all platforms and devices. PYPL's Braintree products serve as a merchant acquiring platform, while iZettle allows small businesses to accept in-store card payments. PYPL also provides merchants with credit products through its PayPal Working Capital and PayPal Business Loan products.

PYPL earns revenue: (1) from consumers through foreign currency exchange fees, instant transfer fees, and interest and fees associated with PayPal Credit products; and (2) from merchants through payment transaction and service fees.

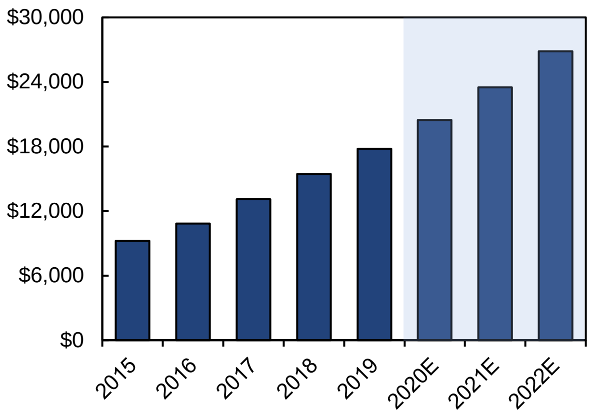
Acquisitions have served as an important growth channel for PYPL alongside organic growth. In December 2019, PYPL acquired a controlling equity interest in Guofubao Information Technology Co. (GoPay), allowing PYPL to provide online payment services in China. Most recently, in January 2020, PYPL acquired Honey Science Corporation for US$4B in cash.

Industry Overview and Competitive Landscape

The credit card processing and money transferring industry is driven by two main factors: e-commerce sales and consumer spending. The popularity of electronic payment methods is expected to increase due to growth in online retail and e-commerce. Additionally, consumer spending will likely increase as a result of easily accessible markets and payment methods, thereby increasing transaction volumes. Lastly, the mobile commerce (m-commerce) market has expanded rapidly in the last five years due to the increase in smartphone applications; its continued growth is an important driver for the industry as the increased convenience of transactions raises transaction volumes.

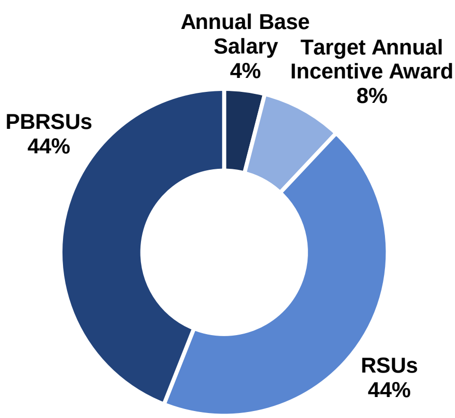
Major industry competitors include Visa (NYSE: V) and Mastercard (NYSE: MA). Additionally, Square (NYSE: SQ), a relatively new competitor, has seen growth due to widespread adoption of its systems by small businesses. Key factors that influence the competitive positioning of industry players include: (1) unit prices of transactions; (2) accuracy and quality of transaction processing; (3) reputation and brand recognition; and (4) customer and operations support and relations. Although the credit card processing and money transferring industry is currently fragmented, PYPL is well positioned to claim greater market share moving forward due to its large customer base and substantial transaction volumes.

Figure 2: Revenue Growth (US$mm)



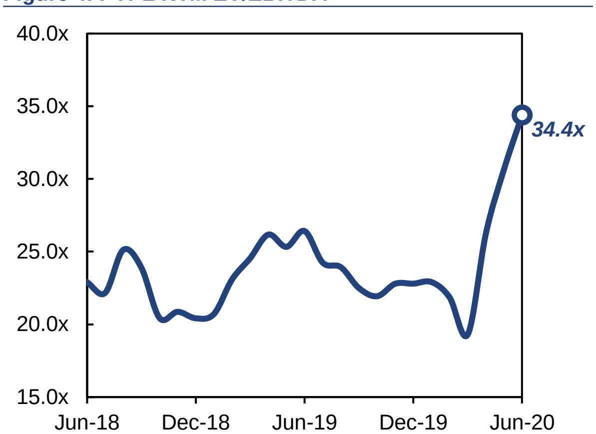
Source: Company Filings, CPMT Estimates

Figure 3: CEO Compensation (2019)



Source: Company Filings

Figure 4: PYPL NTM EV/EBITDA



Source: S&P Capital IQ

Growth Profile and Financial Health

Since its spin-off from EBAY in 2015, PYPL has seen rapid and consistent growth, both in number of consumer and merchant accounts, as well as in earnings. As of 2019, PYPL had 305mm active accounts, of which 281mm were consumer accounts and 24mm were merchant accounts. This represents a 14.3% CAGR over 2015 levels. Similarly, total payment volume (TPV) grew from US$282B in 2015 to US$712B in 2019. This growth has further accelerated in 2020 as e-commerce has gained prevalence in response to COVID-19. In April 2020 alone, new account activations reached 7.4mm, compared to 10mm organic activations during the entirety of Q1 2020. The CPMT believes that strong e-commerce and m-commerce will remain a tailwind for PYPL throughout the remainder of 2020 and that there is a strong runway for growth given the massive size of PYPL’s total addressable market (TAM) globally.

Financially, this has translated into a 21% free cash flow CAGR for PYPL from 2014-2019, while revenue has nearly doubled over the same period, growing from US$9.3B to US$17.7B. While PYPL has a lower margin business model than its credit card peers (24% adjusted EBITDA margin versus 60% and 69% for MA and V, respectively), it nonetheless has strong cash generation abilities, bolstered by low capital intensity. Together with managerial discipline in capital allocation, this has allowed PYPL to fund numerous acquisitions to accelerate growth without unduly compromising balance sheet health. With a massive cash and short-term investment position of US$10.2B, PYPL has negative net debt of US$2.2B, translating into a Total Debt/LTM EBITDA ratio of only 1.8x as of Q1 2020. This balance sheet strength places PYPL in a resilient position in the face of continued macroeconomic uncertainty expected for the remainder of 2020.

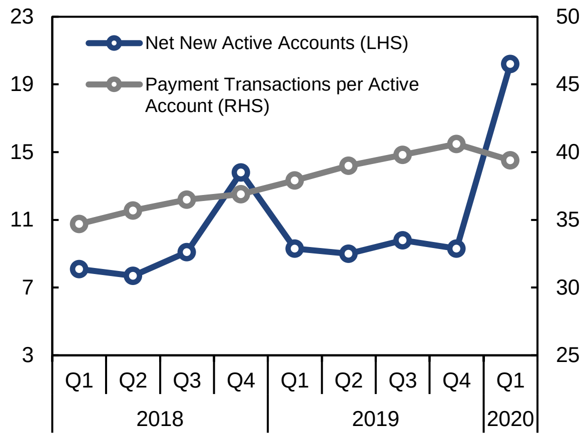
Management

PYPL's President and CEO, Daniel Schulman, joined the Company in September 2014 to lead its separation from eBay into its next phase as an independent business. He has extensive experience in payments and mobile technology, having previously held leadership positions at American Express, Virgin Mobile USA, and AT&T. Additionally, executive compensation is closely aligned with the creation of long-term value for shareholders. In 2019, CEO compensation was composed of 88% long-term incentives (in the form of restricted stock units) and was 52% performance based.

Valuation

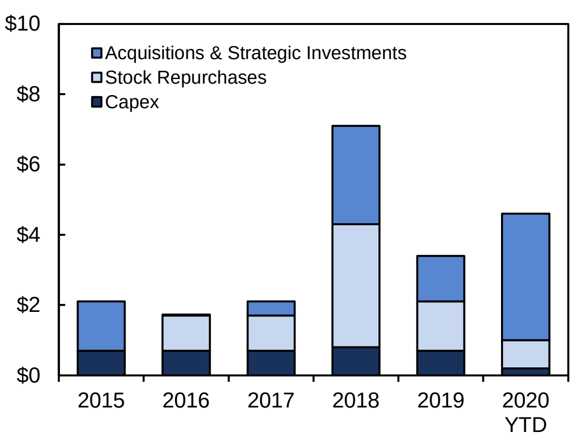
PYPL was valued using a 10-year DCF with a WACC of 7.22%. A 10-year time horizon was chosen to more accurately forecast PYPL’s growth trajectory as it is currently in a high-growth stage. The target price of $191 was derived through a 50/50 blend of (1) the Gordon growth method (assuming a terminal growth rate of 2.75%) and (2) applying an EV/EBITDA exit multiple of 25.0x. PYPL has historically traded at a premium relative to its credit card peers (NYSE: AXP, MA, V), which we believe is justified given PYPL’s technology-oriented platform, strong brand recognition, and growth runway. PYPL’s trading multiples have expanded rapidly since April 2020, reaching 34.4x NTM EV/EBITDA in June 2020. This can be partially attributed to high levels of consumer e-commerce adoption and engagement due to COVID-19. While the growth estimates used in determining our target price were conservative, the CPMT nonetheless believes that PYPL’s currently inflated valuation leaves limited room to realize significant upside.

Figure 5: Account Growth (mm) & Transactions



Source: Company Filings

Figure 6: Capital Allocation (US$B)



Source: Company Filings

COVID-19 Impact and Catalysts

The COVID-19 pandemic has accelerated the secular shift towards digital payments as a result of changes in consumer purchasing behaviours due to social distancing measures and public health concerns. PYPL is well positioned to withstand the impacts of the pandemic due to the diversity of its customer base across products and geographic locations. Some portions of PYPL's business, such as travel and events revenue, were materially impacted by the pandemic. However, TPV increased by ~22% YoY in April 2020, reflecting the shift to digital payments in other parts of the business (e.g., the widespread adoption of e-commerce and new categories such as groceries). Furthermore, a significant portion of its travel and events exposure resides within Braintree, which has lower gross margins compared to PYPL's core business; therefore, poorer performance in this segment has less of an impact on the Company's long-term bottom line performance.

PYPL continues to invest in contactless payments through QR codes in-store. The current physical POS initiative is more focused than past attempts at physical retail penetration due to material demand from merchants driven by the COVID-19 pandemic. Despite the trend towards e-commerce, physical sales still account for ~84% of retail sales in the U.S. The adoption of QR codes provides future upside potential as it would open a new revenue stream for PYPL.

Key Risks

As a global company, PYPL is inherently exposed to FX risk due to significant revenues (~46% of total revenue in FY 2018) and costs denominated in foreign currencies. Furthermore, PYPL is exposed to risks of increased competition for online checkout market share. Competitive threats include the development of Payment Request API by World Wide Web Consortium, the Secure Remote Commerce initiative, and large technology companies that have made developments in payments (e.g., Amazon, Apple, and Google). Lastly, any transaction cost pressures relating to the "Choice" initiative (PYPL's partnership with networks and major banks to allow consumers to easily opt to pay with any method they choose) could lead to increased funding costs for PYPL.

Investment Recommendation

PYPL is well positioned to take advantage of the shift towards digital and mobile payments. With a high level of brand recognition and global, cross-border capabilities, PYPL has an extensive TAM and we expect it to capture increased market share moving forward. Furthermore, PYPL's under-levered balance sheet relative to peers provides it with the capital allocation flexibility to pursue both organic and inorganic growth opportunities. However, the CPMT has concerns surrounding PYPL's valuation as it currently trades at an inflated multiple of 34x NTM EV/EBITDA versus its pre-COVID-19 two-year average multiple of 23x. Our analysis of PYPL's intrinsic value also indicates limited room for share price appreciation. As a result, the CPMT currently recommends no action, but will continue to monitor the name moving forward.