Value Investor INSIGHT
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Worth Checking Out?

While some air came out of a number of tech companies' stocks in 2022, few deflated in the market's estimation to the extent PayPal did. Jim Falbe of Saguaro Capital explains why he thinks the market's still-dour outlook has gone too far.

Even in a world where time seems to move ever faster, PayPal's shift from go-go growth stock to beaten-down value happened quite quickly. Two years ago the electronic-payments company's shares traded in the high-$200s, over 60x forward earnings, and some Wall Street analysts touted it as a potential Western version of China's WeChat, the ubiquitous super-app used for messaging, shopping, payments, gaming and any number of other daily activities.

It's been pretty much downhill since. Stalled growth in PayPal's core business and moderation in pandemic-fueled e-commerce spending have dramatically altered the market's once rosy view. The shares today trade at 20% less than their lowest point in the pandemic and at a below-market 13x forward EPS. "We never thought this was going to the moon, but now we don't think it's just going by the wayside either," says Saguaro Capital's Jim Falbe. "You can have an opinion somewhere in the middle and find the stock very attractive at the current price."

The company's business can be broken down into three main pieces. The primary profit driver today is the traditional PayPal service, used by more than 430 million account holders at least once over the past year to pay for a purchase electronically at one of the nearly 30 million businesses sporting a PayPal button to make payments. The company like any other merchant acquirer earns a fee on each transaction, closer to 1% of the total sale from large sellers and up to 3.5% from smaller firms. Falbe estimates that this revenue stream accounts for roughly 55% of overall gross profit.

The fastest-growing business is Braintree, which PayPal has built into the #3 market player – on the heels of privately held Stripe and Europe's Adyen [Amsterdam: ADYEN] – in providing payment-processing services on an unbranded basis to a wide variety of e-commerce retailers, again earning transaction fees on total

INVESTMENT SNAPSHOT

PayPal
(Nasdaq: PYPL)

Business: Operates a proprietary, multi-currency global technology platform that links merchants and consumers to facilitate the processing of payment transactions.

Share Information (@6/29/23):

Price	**65.86**
52-Week Range	58.95 – 103.03
Dividend Yield	0.0%
Market Cap	$73.48 billion

Financials (TTM):

Revenue	$28.07 billion
Operating Profit Margin	15.9%
Net Profit Margin	9.6%

Valuation Metrics
(@6/29/23):

	PYPL	S&P 500
P/E (TTM)	27.9	19.6
Forward P/E (Est.)	12.8	19.8

Largest Institutional Owners
(@3/31/23 or latest filing):

Company	% Owned
Vanguard Group	8.6%
BlackRock	6.9%
State Street	4.1%
Comprehensive Financial Mgmt	2.7%
Geode Capital	1.9%

Short Interest (as of 6/15/23):

Shares Short/Float	1.9%

THE BOTTOM LINE

While he didn't think the company's stock was going to the moon two years ago, Jim Falbe also doesn't think it's necessarily going by the wayside today either. Assuming that its traditional business is more stable and competitively advantaged than the market seems to expect, he arrives at a mid-point fair value for the shares today of around $110.

Sources: Company reports, other publicly available information transaction revenue. As the third piece of the puzzle, the company also benefits from its PayPal and Venmo account holders transferring money among themselves, charging fees for cross-border transactions and for expedited transfers to customer checking accounts. It also earns interest on the nearly $40 billion held at any given time in such accounts, which has become a material earnings contributor as interest rates have increased.

The market's main concern today is the legacy PayPal-button business, whose business model is under assault from various directions. Apple Pay continues to gain traction for both online and in-store transactions, streamlining the payment process in a similar way to PayPal. Many small and medium-sized businesses have gravitated to platforms such as Shopify and Amazon's marketplace, which have their own primary payment-checkout functionality. Even the Google Chrome browser's auto-population of credit-card data makes the ease of payment using PayPal less unique. As a result, growth in the company's active-user accounts has slowed and transactions using its branded button, while growing, aren't fully keeping pace with still healthy secular growth in e-commerce.

In Falbe's view, the market's seemingly dire outlook for the company's core business is at odds with the reality and also inappropriately ignores PayPal's still-ample competitive advantages. The giant active user base of 430 million who transact annually – with 190 million of those active on a monthly basis – remains a significant draw for business partners. The large user base and the company's years of experience with those users gives it a leg up in data analysis, Falbe says, translating into better fraud protection and better credit underwriting. That serves not only businesses accepting the PayPal button, but he says has also been a strong selling point for Braintree, which is growing at more than 30% per year and appears to be taking market share in merchant acquisitions from Stripe and Adyen.

ON FAIR VALUE:

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The latest key performance metrics also tell a less negative story than the stock price does. Over the three-year period through this year's first quarter, PayPal's number of total active accounts has increased by 33%. The number of payment transactions increased nearly 80%. Total payment volumes are up 85%. The stock, however, at the current price of just under $66 is down 30% from its March 31, 2020 price. "I honestly don't understand the valuation here," says Falbe.

What does he think the shares might more reasonably be worth? With incremental growth from Braintree offsetting below-average growth in the legacy business, Falbe expects PayPal over the next several years to grow its top-line at a high-single-digit annual rate, more or less in line with expected secular growth in e-commerce. He expects from operating leverage and some cost-cutting for adjusted operating margins to return to their 25% level of 2021. Applying a range of historical multiples of operating free cash flow to his normalized bear, base and bull-case estimates for next year, he arrives at a mid-point fair value for the stock today of around $110.

"I wouldn't say we're super bullish here, we just believe this is an excellent business that isn't going anywhere," says Falbe. "I'd actually be happy if the share price declines – they're using 100% of free cash flow to buy back shares that we think are unjustly discounted. If the moat is as solid and stable as we expect, that should work out well."

SAGUARO
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