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Creative Destruction in the Payments Industry

3-SIGMA VALUE

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The global evolution from paper-based to electronic payments is accelerating with the adoption of mobile payment technologies. The benefits are many, including lower cost, reduced fraud risk, targeted real-time marketing, and big data. 3-Sigma Value identifies two powerful secular trends that are driving valuations and determining winners and losers in the payments industry.

Secular Trend Number 1: The magnetic swipe card will be extinct, replaced by mobile wallets with your financial information pre-loaded and protected. Consumers will no longer have to share their personal information with merchants, who are cut out of the payment process altogether. The benefit for merchants is lower cost. Merchants pay on average somewhere between 2.5% and 3.0% of sales (called the merchant discount rate) and are eager to shrink that vig.

Secular Trend Number 2: Checkout lines will be obviated by mobile payments technology. Merchants are eager to adopt technology that eliminates the lag between placing a product in a checkout cart (virtual or otherwise) and actually paying for the product. You pick out four shirts, decide to buy two, and ultimately buy one. Maybe you would have bought two if it didn't take so long and wasn't such a hassle to pay. Customer support in all stores will follow Apple's lead and carry mobile devices that access a payment processing app hosted in the Cloud. Consumer self-checkout is the end game and, as exemplified by Amazon's recently-launched "Amazon Go" retail concept, the end is coming fast.

Identifying the winners is less obvious than the losers, with technologies embedded in giant companies such as Amazon, Apple, Google, Intuit, and PayPal. Ultimately, no matter which virtual wallet gains enough market share to sustain in the new electronic world, there are companies in the traditional payments supply chain with revenue streams in secular decline.

One of 3-Sigma Value's top winners in 2016, short **Verifone Systems (PAY),** was a loser in the month of December, giving back some of the profit, but not all of the profit made during the year. PAY started the year at $28, fell to a low of $15 in October, and then rebounded to $18 on fourth quarter 2016[1] results that contradict the stock's reaction. When a company materially

[1] Fiscal year ends October 31.

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lowers expectations, in this case revenue and earnings expectations for 2017, normally, one would expect its stock price to react negatively.

Verifone Systems (PAY) - Earnings Change vs. Stock Market Reaction			
	2016A	2017 - Old	2017 - New
Non-GAAP EPS	1.66	1.61	1.36
% Change 2017 / 2016		-3.0%	-18.1%
% Change 2017 Old / 2017 New			-15.5%
Stock price prior to release (12/12/16)	16.44		
Stock price next day	17.85		
% Change	8.6%		

Verifone Systems (PAY) is one of two incumbent vendors of point-of-sale (POS) card swipe terminals. The other is **Ingenico SA (ING.France).** Even though Ingenico faces the same creative destruction as Verifone, Ingenico has taken market share and generates higher margins. Its business is more globally[2] diversified and its operational execution superior. In contrast, Verifone has destroyed value through serial acquisitions that have never been adequately integrated, and under-investment in research and development (R&D) leading to a circuitous need to make acquisitions.

In December 2016, Amazon announced its “Amazon Go" retail concept that eliminates checkout lines. Customers check in at the front of the store with the Amazon Go app, take whatever items are desired, and Amazon tracks the items automatically through mobile supply chain technology (e.g. RFID, NFC). When you're done shopping, you just walk out.

The negative impact to PAY’s hardware sales (called system sales) is life threatening unless management is able to quickly build new businesses that replace the lost revenue. PAY reports two segments on its income statement – systems and services. The decline in systems revenue is accelerating, from -5.6% in FY 2016 to -15% to -20% in FY 2017, while services are growing ~10% per annum. The net result is a negative revenue trajectory (-5% according to management).

[2] Verifone and Ingenico are either #1 or #2 in all geographies except for Asia where Ingenico (18% market share) is #2 behind Fujian Newland (21%). Verifone is #7 in Asia with only 5% market share.

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On the morning of December 13, 2016, I woke up expecting PAY to be down at least in line with the cut in its earnings expectations (down 15.5% in 2017) and was stupefied yet again by a market response that is disconnected from the facts. I'm not surprised by the fact that I was surprised. As a stock investor I know to expect the unexpected. Yet I can't help but feel the shock every time. The feeling of profound disappointment, of being overwhelmed by a market that is like the ocean. Standing on the edge of Grace Bay (Turks & Caicos) on the day after Christmas, I found myself in awe of its vastness. There is nothing you can do about direction when the tide is rolling in or out. And there is nothing you can do about the direction of the market. The stock market roared in late 2016 after the presidential election. PAY jumped 8.6% on news that earnings estimates were being cut by 15.5%, totaling an 18.1% decline year over year. This is rotten news, unequivocally rotten, and yet the market perceived it otherwise.

Making matters crazier is the fact that PAY's earnings figures are all non-GAAP figures that bear no resemblance to reality. While non-GAAP earnings are positive, GAAP earnings were negative in 2016, and may or may not remain negative through 2017 at least. Management is guiding to positive GAAP EPS in 2017, but only $0.39 per share, which equates to a rich 45.8x P/E.

Verifone Systems (PAY) - GAAP vs. non-GAAP, per Guidance

	2016A	2017E
Non-GAAP EPS	1.66	1.36
P/E	10.8x	**13.1x**
GAAP EPS	-0.08	0.39
P/E		**45.8x**

In this era of hyperbole, echoes of the internet bubble reverberate in the accounting of technology companies. We at 3-Sigma Value remain as skeptical of the merits of *pro forma* accounting as we were back in the 20th century. In fact, financial reporting has become even more obtuse since then.

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The qualifier *pro forma* is a scourge on financial analysis, enabling management teams to manipulate financial reporting to serve their needs. In Latin it means "as a matter of form" or "for the sake of form" and is applied to practices or documents that are done as a pure formality. In accounting, pro forma is traditionally employed in advance of a planned M&A or other capital structure transaction to project the financials of the new company. When I was an investment banking analyst at Bear Stearns in the mid-1990s we were told that *pro forma* means *as if*. I was asked to produce *pro forma* financial statements for senior investment bankers covering client companies such as Cablevision (CVC) and Time Warner (TWX) *as if* potential mergers or acquisitions or recapitalizations were transacted. This seemed perfectly normal until I began to notice in the years after I left Bear Stearns that many of the Internet IPOs were pitched to investors using *pro forma* to turn losses into profits – *as if* certain types of expenses were excluded. Rather than use the words *pro forma*, some management teams chose a different, more benign qualifier to exclude expenses such as *adjusted*, as in *adjusted* EBITDA or *adjusted* net income.

The Verifone team mixes together non-GAAP and GAAP accounting, acknowledges the complexity, and ultimately communicates to investors in terms of non-GAAP numbers. It's a sly move. They make the financial reporting so complex that they have to simplify it. When simplifying, they eliminate certain expenses. The result is pro forma numbers that are misleading. It doesn't matter whether a technology company builds or buys its intellectual property as long as both forms of expenditure are accounted for properly and consistently when comparing earnings quality and growth. Unfortunately, management's effort to focus investors on non-GAAP numbers obfuscates Verifone's true relative earnings power. Non-GAAP costs exclude acquisition-related costs totaling $131.7 million in FY 2016, or 6.6% of revenue. Similarly, PAY spent $41.8 million on stock-based compensation (2.3% of revenue). In addition, PAY bought back $79.9 million its own shares in the public market in part to offset dilution from stock options – see financing section of cash flow statement – proving there are real cash costs when awarding stock options. It's misleading when stock compensation and acquisition-related expenses are eliminated in the calculation of earnings. These are not one-time items. To calculate earnings without including these items leads to over-valuation.

The crux of 3-Sigma Value's financial analysis is scenario-based. We identify the significant factors/assumptions underlying financial performance, and then vary the factors to reflect optimistic (Upside) and pessimistic (Downside) outcomes. In the case of Verifone (PAY), we identify the following ten (10) factors:

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1. System/Services revenue = with management guiding total revenue down 5%, systems revenue will be down 15%-20% as services revenue grinds higher at ~10% rate

2. Gross Margins = there is little margin leverage as both system and services gross margins converge ~60%

3. Research and development = flattish ~$210 million

4. S&M = 10-12% of revenue

5. G&A = flattish ~$190 million

6. Interest expense = tied to $936.8 million of debt, consisting of Term A loan ($525M), Term B Loan ($196M), Revolver ($205M), and Capital leases ($12M)

7. Stock Compensation = flattish ~$40 million

8. Capital Expenditures = flattish ~$100 million

9. WACC = 10.1%

10. Terminal Value Multiple = 6x-10x range

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Verifone Systems (PAY) - Financial Summary						
Share Price as of 1/9/17						$18.96
x FD Shares Out.						111.3
= Market Capitalization						2,110.2
- Cash & S-T Investments						148.4
+ Total Debt						925.9
+ Minority Interest						34.7
= Enterprise Value (EV)						2,922.4
FYE 10/31		2014A	2015A	2016A	2017E	2018E
Revenue		1,869	2,000	1,992	1,844	1,775
EV / Revenue		1.6x	1.5x	1.5x	1.6x	1.6x
EBITDA		220	275	212	209	202
EV / EBITDA		13.3x	10.6x	13.8x	14.0x	14.4x
EPS		-0.33	0.67	-0.09	-0.10	-0.20
P/E		-57.3x	28.2x	-219.7x	-189.1x	-97.1x
	Live	Upside	Base 1	Base 2	Base 3	Downside
WACC	10.3%					
% Growth in Systems Revenue	-15%	-5%	-10%	-15%	-20%	-25%
PV of UCFC (2017-2019)	344	703	397	344	296	-2
Revenue - 2019	1,737	2,286	1,863	1,737	1,625	1,312
EBITDA - 2019	200	417	236	200	168	11
Terminal Value Multiple (6x-10x)	8.0x	10.0x	8.0x	8.0x	8.0x	6.0x
PV of Terminal Valuation	1,194	3,122	1,408	1,194	1,001	47
Net Debt + Minority Interest	812	812	812	812	812	812
Equity Value	726	3,013	992	726	485	0
per share	6.52	27.07	8.92	6.52	4.35	0.00
Prob-weighted target price	**9.37**					
Upside (Downside)	**-50.6%**					
Implied Multiple of 2019 Revenue	**1.1x**					
Implied Multiple of 2019 EBITDA	**9.3x**					

Conclusion: Verifone (PAY) could be worth $27 (risk = 8 points) or it could be worth $0 (reward = $19 points). On a probability-weighted average, PAY is worth $9.37 (-51%), equal to a very reasonable 1.1x 2019 revenue and 9.3x 2019 revenue.

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