

Equity Research

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Financials

PayPal Holdings, Inc.

Downgrading to Neutral After 4Q17 Report; Role with EBAY Reduced; Valuation Gap with V, MA Too Wide

We are downgrading PayPal Holdings (PYPL) to Neutral (from Buy) and removing our price target of \$81 after the company today following the market close delivered a strong 4Q17 earnings report that was nevertheless not strong enough to justify the stock's lofty valuation, in our view. While we continue to view PYPL as well positioned to be among the leading beneficiaries of the global growth of mobile payments, during the past year the stock has moved from trading at a modest discount to the global payment networks to trading at a healthy premium to them – a valuation gap that we find difficult to justify.

- At the same time, PYPL's risk/reward proposition has become less attractive as the stock appears priced for near-perfection while execution risk remains on several fronts. Investors received a reminder that PYPL does face risks after news hit the tape at about 6:15pm ET today that former parent eBay (EBAY, Not Rated) was replacing the company as its primary payments processor with Adyen BV, a privately-held Dutch firm. That news broke less than two hours after PYPL had touted an extension of its agreement with EBAY while neglecting to note its reduced role.
- PYPL's 4Q17 earnings report once again featured an earnings beat as well as the collection of strong metrics that investors have come to expect from the company, whose shares have more than doubled over the past 12 months. The list of year-over-year growth rates was impressive: FX-neutral revenue was up 24%, FX-neutral transaction processing volume (TPV) was up 29%, and Venmo volume growth was up 86% (although this was slower than the 93% increase in 3Q17).
- With that said, PYPL now trades at 20.2x FY19E adjusted EBITDA versus Mastercard (MA, Not Rated) at 18.9x and Visa (V, Not Rated) at 16.5x. While PYPL's growth rate may merit some premium over MA and V – a point that is debatable given PYPL's place within the global payments food chain – we believe the valuation gap is just too wide.
- Valuation:** Based on our EV/EBITDA valuation analysis of PYPL, we believe its shares will remain within +/- 15% of current levels over the next 12 months. BTIG does not assign price targets to Neutral-rated stocks.

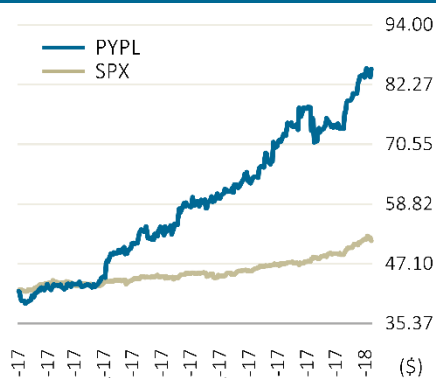
PYPL

\$85.32

NEUTRAL

52 week range \$39.31 - \$85.45
Market Cap (m) \$104,346

Price Performance



Source: IDC

Estimates

| | 1Q17 A | 2Q17 A | 3Q17 A | 4Q17 A | FY17 A | 1Q18 E | 2Q18 E | 3Q18 E | 4Q18 E | FY18 E | FY19 E |
|--------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| EBITDA | 766 | 824 | 838 | 988 | 3,548 | 975 | 970 | 1,007 | 1,248 | 4,199 | 4,753 |
| Diluted EPS (Adj.) | 0.44 | 0.46 | 0.46 | 0.55 | 1.90 | 0.53 | 0.52 | 0.53 | 0.66 | 2.24 | 2.56 |

Source: BTIG Estimates and Company Documents (\$ in millions, except per share amount)

Please Read: Important disclosures and analyst's certification appear in Appendix

- ▶ PYPL announced that prior to the end of 4Q17 it and EBAY, Not Rated) had signed a term sheet confirming that PYPL will continue to be featured on the eBay Marketplace through July 2023 (even as we learned subsequently that Adyen would replace PYPL as EBAY's primary payments processor after PYPL had served in that role for 15 years). The existing deal put in place upon PYPL's separation from EBAY two-and-a-half years ago would have expired in 2020.
- ▶ Management said the terms of the agreement were such that PYPL would not need to alter its medium-term guidance, noting that EBAY represented about 13% of its TPV now, down 900bps over the last two years, and that it would represent significant less in the coming years. However, we believe that as a consequence of Adyen's advent with EBAY that this part of the PYPL story now falls into the "show me" category, representing a new source of uncertainty.
- ▶ We believe the FY18 revenue growth forecast that PYPL offered in conjunction with its 4Q17 report – growth of 15% to 17% at current spot rates, including a negative impact of about 3.5% representing the expected impact of the sale of \$6.8bn in U.S. credit receivables to Synchrony Financial (SYF, Buy, \$44 PT) at an assumed closing date of July 1 – may disappoint some investors after management in October had offered initial guidance for FY18 revenue growth at spot rates of about 20%.
- ▶ PYPL's FY18 non-GAAP diluted EPS guidance in a range of \$2.24 to \$2.30 was perhaps more encouraging, but with the consensus estimate at \$2.24 prior to the report's release it did not represent the kind of forecast that had caused analysts to significantly reset their growth assumptions as several of the company's reports have in recent quarters. Clearly, the expectations bar has been raised meaningfully for PYPL and the company appears to be bumping up against it at this point – a position that makes the surprising EBAY/Adyen news even less palatable.
- ▶ PYPL's transaction margin jumped to 65.1% in 4Q17 from 54.8% in the prior quarter thanks to management's transfer of the company's U.S. credit receivables portfolio to the held-for-sale category. As a consequence, transaction and loan loss rate declined to 3bps from 32bps during the quarter, driving the margin expansion. PYPL's transaction expense rate of 96bps was down by 1bps, offering confirmation that the company's consumer choice programs with V and MA have not driven transaction expenses meaningfully higher as some had feared when those partnerships had been announced.
- ▶ Looking across the spectrum of Financials stocks, we believe PYPL is not particularly well positioned relative to some of the macro trends in the space. Unlike many Financials companies, it is not poised to be a beneficiary of tax reform like others such as SYF. Amidst a rising interest rate environment, investors tend to rotate into regional banks, insurers and other businesses with positive sensitivity to higher rates and out of secular growth stories such as PYPL.

Income Statement

| PayPal Holdings - Operating Mode | Dec-14 | Dec-15 | Dec-16 | Mar-17 | Jun-17 | Sep-17 | Dec-17 | Dec-17 | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Dec-18 | Dec-19 | Dec-20 |
|--|----------------|----------------|-----------------|----------------|----------------|----------------|----------------|-----------------|----------------|----------------|----------------|----------------|-----------------|-----------------|-----------------|
| \$ millions | 2014A | 2015A | 2016A | 1Q17A | 2Q17A | 3Q17A | 4Q17A | 2017A | 1Q18E | 2Q18E | 3Q18E | 4Q18E | 2018E | 2019E | 2020E |
| Net Revenues | 8,025.0 | 9,248.0 | 10,842.0 | 2,975.0 | 3,136.0 | 3,239.0 | 3,744.0 | 13,094.0 | 3,546.6 | 3,646.0 | 3,758.2 | 4,344.9 | 15,295.7 | 17,860.6 | 20,533.9 |
| Transaction expense | 2,170.0 | 2,610.0 | 3,346.0 | 987.0 | 1,064.0 | 1,102.0 | 1,266.0 | 4,419.0 | 1,238.7 | 1,303.4 | 1,350.0 | 1,550.9 | 5,442.9 | 6,653.3 | 8,033.3 |
| Transaction and loan loss | 646.0 | 809.0 | 1,088.0 | 300.0 | 308.0 | 363.0 | 40.0 | 1,011.0 | 312.2 | 322.6 | 341.5 | 388.8 | 1,365.1 | 1,701.9 | 2,160.0 |
| Customer support and operations | 1,055.0 | 1,220.0 | 1,267.0 | 317.0 | 335.0 | 346.0 | 366.0 | 1,364.0 | 360.5 | 371.1 | 382.4 | 404.6 | 1,518.6 | 1,689.8 | 1,849.8 |
| Sales and marketing | 998.0 | 985.0 | 969.0 | 238.0 | 284.0 | 278.0 | 328.0 | 1,128.0 | 270.6 | 314.6 | 307.3 | 362.6 | 1,255.1 | 1,396.5 | 1,528.6 |
| Product development | 890.0 | 947.0 | 834.0 | 214.0 | 232.0 | 240.0 | 267.0 | 953.0 | 255.1 | 257.0 | 265.3 | 295.2 | 1,072.5 | 1,207.4 | 1,321.8 |
| General and administrative | 482.0 | 560.0 | 1,028.0 | 265.0 | 282.0 | 293.0 | 315.0 | 1,155.0 | 304.8 | 310.2 | 322.3 | 330.8 | 1,268.0 | 1,394.8 | 1,534.3 |
| Depreciation and amortization | 516.0 | 608.0 | 724.0 | 183.0 | 201.0 | 194.0 | 227.0 | 805.0 | 214.5 | 229.7 | 221.2 | 258.9 | 924.3 | 1,079.3 | 1,240.9 |
| Restructuring | - | 48.0 | - | 40.0 | - | - | 92.0 | 132.0 | - | - | - | - | - | - | - |
| Total operating expenses | 6,757.0 | 7,787.0 | 9,256.0 | 2,544.0 | 2,706.0 | 2,816.0 | 2,901.0 | 10,967.0 | 2,956.3 | 3,108.5 | 3,189.9 | 3,591.6 | 12,846.4 | 15,123.0 | 17,668.7 |
| Adjusted EBITDA | 2,076.0 | 2,490.0 | 2,793.0 | 766.0 | 824.0 | 838.0 | 988.0 | 3,548.0 | 975.2 | 969.6 | 1,006.6 | 1,247.6 | 4,198.9 | 4,753.2 | 5,206.0 |
| Operating income | 1,268.0 | 1,461.0 | 1,586.0 | 431.0 | 430.0 | 423.0 | 843.0 | 2,127.0 | 590.3 | 537.5 | 568.3 | 753.2 | 2,449.3 | 2,737.7 | 2,865.2 |
| Other income (expense) | (7.0) | 27.0 | 45.0 | 7.0 | 17.0 | 28.0 | 21.0 | 73.0 | - | - | - | - | - | - | - |
| Income (loss) before income taxes | 1,261.0 | 1,488.0 | 1,631.0 | 438.0 | 447.0 | 451.0 | 864.0 | 2,200.0 | 590.3 | 537.5 | 568.3 | 753.2 | 2,449.3 | 2,737.7 | 2,865.2 |
| Income tax expense | 842.0 | 260.0 | 230.0 | 54.0 | 36.0 | 71.0 | 244.0 | 405.0 | 59.0 | 53.8 | 56.8 | 75.3 | 244.9 | 273.8 | 286.5 |
| Net income | 419.0 | 1,228.0 | 1,401.0 | 384.0 | 411.0 | 380.0 | 620.0 | 1,795.0 | 531.3 | 483.8 | 511.5 | 677.9 | 2,204.4 | 2,463.9 | 2,578.6 |
| Diluted EPS - GAAP | \$0.34 | \$1.00 | \$1.15 | \$0.32 | \$0.34 | \$0.31 | \$0.71 | \$1.47 | \$0.43 | \$0.40 | \$0.42 | \$0.56 | \$1.80 | \$2.04 | \$2.17 |
| Diluted EPS - Adjusted | \$1.10 | \$1.29 | \$1.50 | \$0.44 | \$0.46 | \$0.46 | \$0.55 | \$1.90 | \$0.53 | \$0.52 | \$0.53 | \$0.66 | \$2.24 | \$2.56 | \$2.81 |
| Diluted shares outstanding | 1,222.0 | 1,227.5 | 1,217.5 | 1,216.0 | 1,215.0 | 1,223.0 | 1,228.0 | 1,220.5 | 1,226.0 | 1,224.0 | 1,222.0 | 1,220.0 | 1,223.0 | 1,207.5 | 1,187.5 |
| Revenue growth | 19.3% | 15.2% | 17.2% | 16.9% | 18.3% | 21.4% | 25.6% | 20.8% | 19.2% | 16.3% | 16.0% | 16.0% | 16.8% | 16.8% | 15.0% |
| Operating margin | 15.8% | 15.8% | 14.6% | 14.5% | 13.7% | 13.1% | 22.5% | 16.2% | 16.6% | 14.7% | 15.1% | 17.3% | 16.0% | 15.3% | 14.0% |
| EBITDA margin | 25.9% | 26.9% | 25.8% | 25.7% | 26.3% | 25.9% | 26.4% | 27.1% | 27.5% | 26.6% | 26.8% | 28.7% | 27.5% | 26.6% | 25.4% |
| Net income margin | 5.2% | 13.3% | 12.9% | 12.9% | 13.1% | 11.7% | 16.6% | 13.7% | 15.0% | 13.3% | 13.6% | 15.6% | 14.4% | 13.8% | 12.6% |
| Tax rate | 66.8% | 17.5% | 14.1% | 12.3% | 8.1% | 15.7% | 28.2% | 18.4% | 10.0% | 10.0% | 10.0% | 10.0% | 10.0% | 10.0% | 10.0% |

Source BTIG Estimates and Company Reports

BTIG Covered Companies Mentioned in this Report

PAYPAL HOLDINGS, INC. (PYPL, Neutral, \$N/A PT; Current Price: \$85.32; Analyst: Mark.Palmer)

SYNCHRONY FINANCIAL (SYF, Buy, \$44.00 PT; Current Price: \$39.68; Analyst: Mark.Palmer)

Appendix: Analyst Certification and Other Important Disclosures

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PayPal Holdings, Inc. (PYPL, Neutral)

Valuation: Based on our EV/EBITDA valuation analysis of PYPL, we believe its shares will remain within +/- 15% of current levels over the next 12 months. BTIG does not assign price targets to Neutral-rated stocks.

Risks: The primary risks to PayPal include: competition from mobile wallet offerings and others, pressure on take rates, security risks, regulatory risks, regulatory risks and reliance on third-party banks for credit-product issuance. Upside risks: continued growth above expectations and an acquisitions of the company.

PayPal Holdings, Inc. (PYPL)



Note: Closing Price and Target Price have been adjusted for corporate actions.

| Date | Closing Price (\$) | Target Price (\$) | Analyst | Rating |
|-----------|--------------------|-------------------|-------------|--------|
| 20-Jul-15 | 39.35 | 48 | Mark Palmer | Buy |
| 27-Apr-17 | 47.72 | 53 | Mark Palmer | Buy |
| 26-Jun-17 | 52.73 | 63 | Mark Palmer | Buy |
| 06-Sep-17 | 62 | 70 | Mark Palmer | Buy |
| 20-Oct-17 | 69.80 | 81 | Mark Palmer | Buy |

Other Disclosures

Additional Information Available Upon Request

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