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THE BIG SECRET ON WALL STREET

The $1 Trillion Powerhouse

- AI Powers a Competitive Business
- The Classic Fintech Disruptor Could Deliver 20% Annual Returns

FROM THE DESK OF PORTER STANSBERRY

SPECIAL REPORT

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The $1 Trillion Powerhouse

AI Powers a Competitive Business

This Classic Fintech Disruptor Could Deliver 20% Annual Returns

"Watch *this*."

Those were *almost* Elon Musk's last words.

It was March 2000, and 28-year-old Musk had just dropped a cool million on the legendary McLaren F1 – one of the fastest supercars in history. The F1 had a gold-plated engine and topped out at just over 240 mph.

It was an intimidating "mine is bigger than yours" car. So, naturally, Musk figured he'd take rival entrepreneur Peter Thiel out for a spin.

He should probably have signed up for a couple of extra driving lessons first.

Musk and Thiel – whose offices were next door to each other in a Silicon Valley high-rise – were developing competing online payments systems. Back then, most online business transactions relied on physical checks – and the notion of paying online was revolutionary.

Musk's company, X.com, and Thiel's, Confinity, both offered a platform to make secure online payments while protecting sensitive credit card details. And both companies grew like kudzu, seeing double-digit increases in users on a weekly basis during 1999.

The rival teams slept in the office, brought their kids to work on weekends, and gave away millions of dollars – in $10 and $20 increments – as "signup incentives" for customers curious to try online payments. "It was kind of a race to see who could run out of money the fastest," Musk said later.

By early 2000, the Hatfield-and-McCoy-style feud between X.com and Confinity had escalated to the point of semi-serious death threats in memos and motivational posters. "KILL THEM DEAD. DIE. DIE. DIE" Musk exhorted employees in one email – while a Confinity employee celebrated his own birthday with a cake that said "Die X.com."

After a year of living in a pressure cooker – and postponing his honeymoon – Musk just needed to crack the lid a little. So he bought the McLaren.

There was just one problem: Elon didn't realize that driving a 627-horsepower beast isn't the same thing as getting behind the wheel of an off-the-lot Honda.

What he lacked in experience, Musk – kind of – made up for in bravado. "Watch this," he said as Peter Thiel climbed into the shotgun seat. Then Musk floored it.

And… flipped it.

The seven-figure car promptly hit an embankment… went airborne… and landed belly-up, with shattered windows and a snapped suspension.

Neither Musk nor Thiel were wearing seatbelts. Miraculously, the two tech geniuses crawled out of the wreckage without a scratch. (The uninsured McLaren, however, required extensive repairs.)

X.com and Confinity could *both* have died that day, but they survived. It seemed like a sign. Musk and Thiel – after hitchhiking back to the office – officially ended their rivalry and joined forces.

But the way forward was far from a smooth stretch on the Autobahn…

Musk and Thiel continued to feud from opposite sides of the boardroom. Musk won out on the company name, which stayed X.com thanks to greater brand recognition. But he couldn't get Thiel to budge on the entity's business model. Thiel wanted to stick with the online payments sector, while Musk wanted to expand into a wide variety of other markets like online brokerage and insurance (today, he still harbors dreams of an "everything app" called X.com).

In September 2000, Musk finally took his wife on their long-delayed honeymoon – and while the happy couple was flying to Australia, the board voted to fire Musk and install Thiel as X.com's CEO.

Soon thereafter, the company was rebranded to PayPal. Then, in 2002, eBay bought PayPal for $1.5 billion – handing Musk, who'd retained his ownership stake in the company, a handsome payday.

Today, Musk and Thiel are on much friendlier terms, with Thiel joking about the car crash, "I'd achieved liftoff with Elon, but not in a rocket." The McLaren – now repaired – recently went up for auction at England's Goodwood Festival of Speed.

And PayPal – an attractive business that has also spun off the road in recent years – is now refurbished and up for sale at a compelling price...

Uncle Carl Unshackles PayPal

In 2000, online auction site eBay had over 12 million users with 4.5 million items available for sale, making it the largest e-commerce site in the world.

But until eBay bought PayPal, its users could only pay with checks and money orders, delivered via snail mail. The deal was transformative for eBay, and also for PayPal, which became the default payment option for eBay auctions. PayPal's secure and fast online payment system quickly became the top choice for eBay users, offered on 70% of auction listings.

The size of PayPal's network grew from 2 million users at the time of the acquisition in 2002 to 100 million users across 190 global markets by 2011 – making PayPal the undisputed leader in online payments.

However, by 2014, eBay's growth stalled out as a new cohort of e-commerce competitors began taking market share. eBay's revenues had grown every year from $430 million in 2000 to $16 billion by 2013, but in 2014 sales began to fall (and have yet to recover to their 2013 highs).

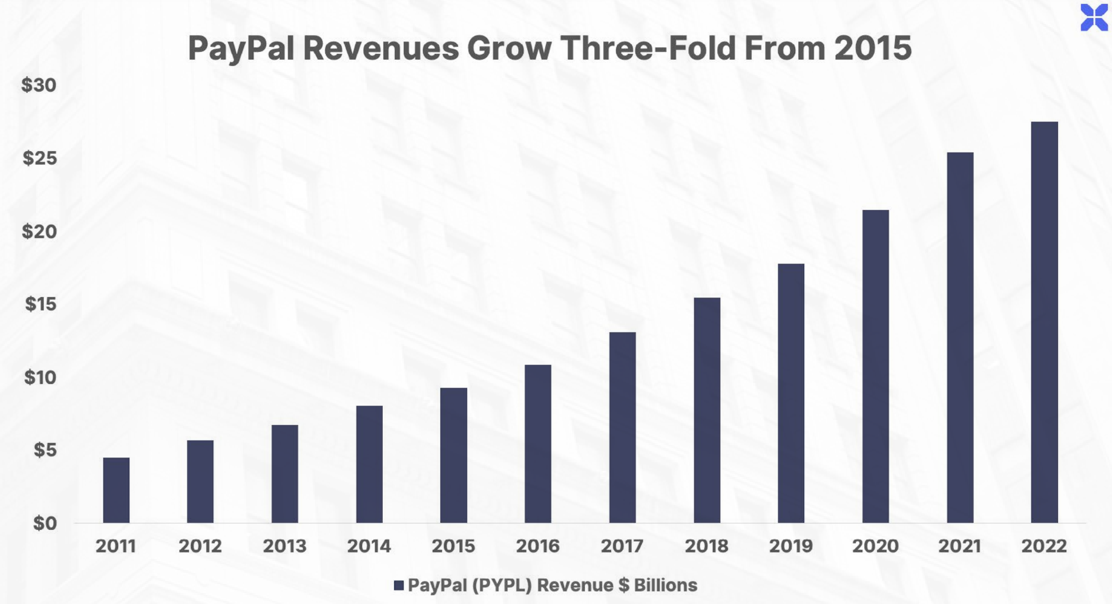
That meant that PayPal, the global leader in digital payments, was "trapped" inside a stale auction site with an outdated 1990s-style interface.

And that spelled opportunity for legendary investor and corporate activist Carl Icahn.

In February 2014, after buying 46 million shares of eBay, about 3.7% of the company, Icahn published an open letter to eBay shareholders, pushing them to spin off PayPal into a separate, independent company.

Icahn didn't hold back on his criticism of eBay's mismanagement, writing that the CEO "seems to be completely asleep or, even worse, either naive or willfully blind." He said that "it doesn't make sense that a global payment system is a subsidiary of an auction website... it's as if Target owned Visa...."

eBay's board caved and spun off PayPal to become an independent company in July 2015, when it began trading on the Nasdaq as PYPL.



Since becoming independent, PayPal's revenues have grown three-fold, from $9.2 billion in 2015 to $27.5 billion in 2022.

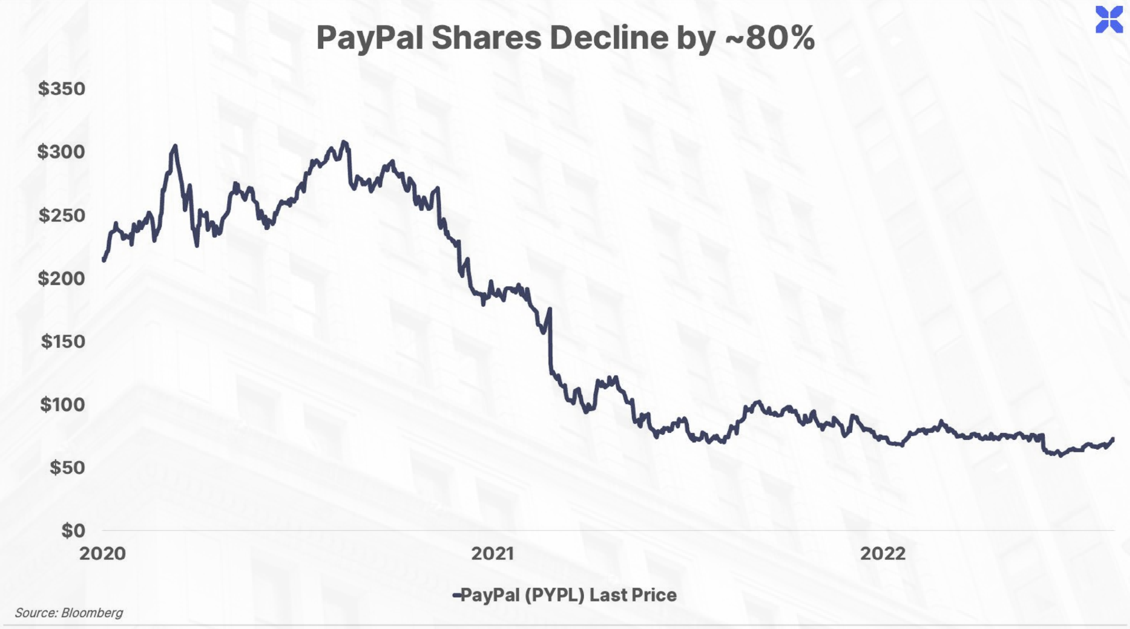
Today, PayPal is one of the world's largest digital-payment networks, with 435 million users around the world. This includes 400 million consumer accounts and 35 million merchant accounts.

The business tends to grow in line with the overall increase in e-commerce transactions. That meant that PayPal was a COVID-era winner, as consumers trapped at home spent their stimulus checks online. PayPal's revenues grew 43% in 2020 – 2021, driving its share price to new all-time highs above $300 in mid-2021.

Riding high on the pandemic, PayPal's management pursued a series of expensive acquisitions and investments into ancillary business lines to keep the growth going (more on this later). But after those investments failed to deliver the promised growth, PayPal was left with a bloated cost structure, just as the pandemic-fueled surge in e-commerce slowed in 2022.

Higher expenses and slowing growth squeezed PayPal's profit margins, which fell to a record low of 8.6% in Q2 2022, down from a historical range of 20% - 22%. Meanwhile, a new cohort of digital-payment competitors, including Apple, Stripe, and Adyen, have been pressuring PayPal's market.

This confluence of factors sent PayPal's share price plunging by roughly 80% from its 2021 peak, to around $60 today.



Despite these recent stumbles, PayPal's core payments business is a highly capital efficient, world-class asset with an enduring competitive moat. As we'll show, a key part of PayPal's moat comes from its best-in-class fraud detection. This puts more money into merchant pockets, and it's made PayPal the payment processor of choice for the world's largest online merchants. Now, PayPal is harnessing the power of AI to expand this best-in-class fraud-fighting abilities and further separate itself from the competition.

The company is also using AI to become more efficient. PayPal has leaned on AI-based software development to reduce engineering workloads by 20% - 40%. This is part of management's ongoing efforts to aggressively cut costs and return more cash to shareholders. In this issue, we'll make the case for a rebound in PayPal's business to new record highs in profitability, which could deliver compounded annual returns upwards of 20% over the next five years.

Best of all, the market hasn't caught onto the opportunity yet, with PayPal's shares trading at one of its cheapest valuations on record.

A Quick Look At Paypal's Business Model

On the surface, PayPal has a simple business model. It processes digital payments that consumers make to online merchants, and to fellow consumers in peer-to-peer transactions. PayPal collects a fee, known as a "take rate," for processing these payments. In 2022, PayPal's take rate was 1.9% on $1.4 trillion in transactions, generating $28 billion in revenue.

Paypal's payments can be broken down into two key segments: branded and unbranded payments.

Branded payments refer to any transactions made through the "PayPal button." The PayPal button was the company's original payment method that gained widespread popularity on eBay and other online sites in the late 1990s and early 2000s. Branded payments through the PayPal button make up roughly 30% of the company's total transaction volumes, or about $400 billion in 2022.

Unbranded payments make up the second key component of PayPal's business. These are transactions made through third-payment networks, like debit cards, credit cards, or direct bank connections.

In 2013, PayPal acquired Braintree for $800 million in order to begin offering unbranded payments to merchants. Braintree is what's known as a "full stack payment processor." This means that it powers the entire customer buying process, including building the checkout page, verifying customer identities for fraud-detection and prevention, and communicating with credit card networks and the banking system to process a range of different payment types.

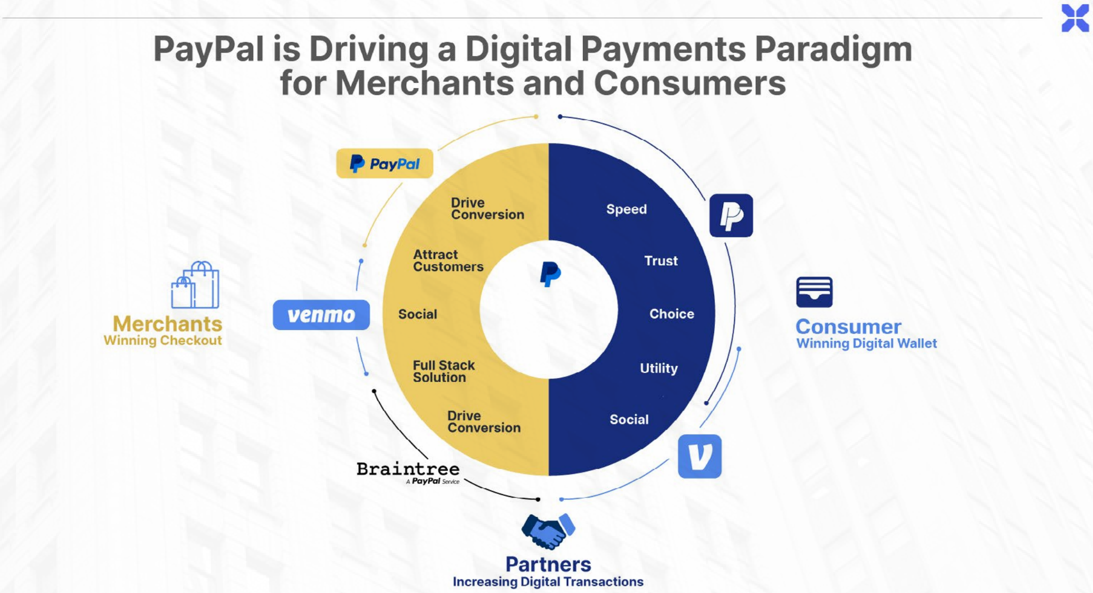
Full stack payment processors like Braintree allow merchants to manage all of their payment options from one platform.

The Braintree purchase came with a hidden gem – a peer-to-peer payment provider called Venmo.

When PayPal acquired Braintree in 2013, Venmo was a niche app. But it grew over time, and today, Venmo has roughly 90 million active accounts – nearly the same number PayPal had across its entire business when it split from eBay in 2015. It's become a key driver of PayPal's network growth in recent years.

PayPal combines its branded payments system with Braintree and Venmo into a two-sided ecosystem that connects merchants and consumers. This ecosystem is the key to PayPal's enduring competitive advantage.

In addition, Braintree offers merchants access to PayPal's network of 400 million



Source: PayPal Investor Relations

consumer accounts and all of the data that comes with it. This allows Braintree to offer merchants targeted marketing opportunities to PayPal's user network that standalone payment processors can't.

Looking ahead, PayPal's data advantage will only grow stronger in the new era of artificial intelligence (AI).

Big Data Could Make PayPal One of the Biggest AI Winners

Data is king in the AI age.

Like the human brain, AI algorithms constantly learn and adapt to better solve problems over time. Thus, the richer the data set feeding an AI algorithm, the more precise its solutions become.

As discussed previously, PayPal's data advantage over its peers is two-fold. First, it has the longest history of customer-transaction data among all online payment providers. Second, PayPal's unique two-sided payment network provides an unmatched data set that spans both the consumer and merchant side of the transaction. PayPal is now feeding this rich transaction data into its AI algorithms to do things like improve its already best-in-class fraud-detection capabilities. In the company's Q2 2023 earnings call, management explained:

> *"We capture 100% of the data flows, which really is feeding our AI engines... it's fueling our ability to have best-in-class authorization rates in the industry, and the lowest loss rates in the industry."*

Likewise, PayPal is using AI to improve the value of merchant promotions it can offer to the 400 million consumers in its network. The self-learning aspect of PayPal's AI software allows it to test the efficacy of various promotions and eventually iterate toward the most valuable ones.

In the past, PayPal relied on software engineers to iterate new approaches to fraud management and marketing promotions. Now, AI offloads a substantial portion of this workload, unlocking higher capital efficiency for the business.

On that same Q2 2023 earnings call, PayPal management reported a 20% - 40% increase in engineering productivity from adding AI tools into its software-development efforts. The potential AI productivity boost could drive a meaningful increase in PayPal's profitability, as the company has struggled with a bloated staff in recent years (more on this later).

The company is still in the early innings of experimenting with the powerful new AI tools coming to market. With the richest pool of transaction data in the industry to feed its algorithms, PayPal stands to become one of the biggest payments winners from the AI revolution.

And that will further cement its entrenched competitive advantages as the longest-running, most-trusted digital-payment providers in the world.

Three Ways Paypal Mints Money with AI

PayPal operates the dominant digital payments network and offers an unmatched suite of branded and unbranded payments. Thanks to the value it offers to both merchants and consumers, it is able to charge some of the highest take rates in the industry.

PayPal processes more than 40 million transactions per day on more than 430 million consumers and merchants. In each transaction, there's an abundance of data that flows from consumers to businesses and back again.

Since PayPal's inception, it used machine learning to fight fraud. Machine learning is a branch of AI that uses data and algorithms to imitate the way humans learn through trial and error – i.e., if a baby puts his hand on a hot stove, he learn it's hot... and not to touch. PayPal's access to data was a large contributor to the success in detecting and preventing fraud, but PayPal's access to data is much more valuable than preventing fraud...

You see, the rise of high-speed internet and the adoption of smartphones have enabled data to become the currency of today's technology-powered world. Today, the cost to acquire data is minimal compared to 10 to 15 years ago. As data has become easier and cheaper to access, PayPal set sights on using data to better serve consumers and merchants with value-added services.

More Value for Merchants

PayPal supports a wide range of critical functions for small businesses and enterprises – including accepting payments, financial services, and business operations. When a merchant employs PayPal's point-of-sale system, the platform becomes a critical component to their business since it becomes the customer-facing component for making sales both online and in-store. PayPal captures data from every sale, and this gives a deep understanding of the businesses using its services. Capturing data gives PayPal insights into its merchants cash flows, their busy seasons, their sales, and even when the company gets paid. PayPal then uses what it learns to offer those merchants financial services tailored to their businesses needs.

PayPal offers merchants a long menu of options – business loans, working capital loans, credit and debit cards, invoicing, product returns, and reporting tools. When merchants choose PayPal to provide these services, PayPal becomes ingrained into the merchants' operations, where it can help them generate more sales. In turn, these merchants grow their businesses and increase their payment volume on PayPal's network, resulting in higher profits for PayPal.

For example, if a PayPal small and medium-size business ("SMB") needs a working capital loan, PayPal can leverage its data from processing the merchant's sales to understand whether or not the merchant will be able to pay off the loan. Better yet, using its accumulated data, PayPal might identify that a SMB could use a working capital loan before the people running the business realize it. PayPal can then suggest a loan configuration best suited to the merchant.

PayPal uses data from previous months and years to better understand the merchant's sales-cycle and whether or not it should extend a loan. This differs from a bank loan, where the bank typically doesn't have a true picture of a merchant's sales history and is more likely to turn down the loan. In return, merchants grow loyal to PayPal and can grow their businesses with other services PayPal offers all while increasing their transaction volume on PayPal's network.

This rich data feeding into PayPal's algorithms enables the company to unlock substantial value for merchants. Since PayPal touches so many parts of a merchant's business, it can use AI to better understand the merchant and recommend financial services before the merchant realizes it may need them. By leveraging data from a merchant's sales in real-time, PayPal doesn't have to assume how a business is performing on a day-to-day basis or how it performed two years ago (if it were a PayPal customer) to offer the most relevant financial services. PayPal leverages AI to better serve and drive more sales at PayPal merchants.

PayPal gets to know merchants by using its point-of-sale ("POS") system as a method to begin a relationship and eventually offer services that allow them to grow and flourish. All while PayPal benefits from processing more transactions, which directly feeds into the company's bottom line. However, on the other side of the merchant is a consumer, another customer base to tap into with a different set of value-added services.

A Tailored Experience for Consumers

PayPal targets consumers through the original PayPal button which gained widespread adoption in the late 1990s and early 2000s as the OG method to pay over the internet. PayPal's expanded over the years and Venmo, which started as a peer-to-peer money transferring service, has evolved into a digital wallet where consumers can shop for the best deals from one mobile application.

When a Venmo user selects to "explore offers," the platform creates a custom experience based on previous shopping habits. Over time, as a consumer uses a Venmo debit or credit card or the PayPal button, PayPal can better understand the consumer and drive sales to PayPal merchants through promotions or cash-back rewards – 5% cash back is fairly standard.

PayPal leverages data from consumer transaction history to drive more sales at PayPal merchants, which in turn increases PayPal's transaction volume.

Now that a consumer's spending history and banking data can be used in underwriting financial products, it's easier for PayPal to identify and approve worthy borrowers for its various financial services. With more data points, PayPal can analyze a potential borrower's account balances, payment history, and transactions to offer a financial service that's more competitive and ultimately better for the consumer. It also gives PayPal even more intel into where consumers are spending, which can then be used to drive consumers to PayPal merchants.

As data has become more prevalent amongst merchants, the same is true for consumers. With over 400 million consumer accounts, PayPal has an advantage over its competitors when it comes to leveraging data. This is how PayPal's able to have the highest authentication rates in the industry.

Buy Now, Pay Later

Credit is at the heart of banking. Credit is how banks lend money, and it's how consumers or businesses get funds to pay for things, whether they are buying a book, a bed, or launching a new produce line.

When a customer lands on an online checkout page or an in-store checkout line and doesn't make the purchase, there are many reasons why. One reason is not having an affordable means to access credit. This is why PayPal offer a credit card and now its Buy-Now-Pay-Later (BNPL) service.

BNPL is a financing option that allows a consumer to purchase something now and pay for it over time. A company like PayPal gives the merchant the full amount of the transaction and the customer will settle up with PayPal over several weeks or months – and will sometimes pay interest depending on the terms. The terms for each "loan" differ. BNPL is evolving and could become a new method for underwriting credit, where AI uses data to determine whether someone should receive credit, and under what terms.

Rather than extending a lump sum of credit, the new BNPL paradigm allows for transactions to be underwritten on an item-by-item level. By underwriting at the transaction level, PayPal can better understand whether the consumer is in the financial position to pay it off.

There's an abundance of data in every transaction, from location to time of day, that is valuable when it comes to risk management and fraud. For example, if the transaction occurs in a random location in the middle of nowhere, PayPal may not approve the transaction. Similarly if it takes place other than where previous transactions have been, it may get flagged as a fraudulent transaction.

Merchants love BNPL because fewer customers are turned away at the point-of-sale and because it can attract new customers and increase average order sizes. Already, PayPal's BNPL option has increased checkout volumes by 30% and has reduced churn by 10 - 15%.

By offering additional options for PayPal's consumers to pay for things at the POS, customers paying with PayPal have a variety of options to fund their purchase, whether using balances in your Venmo account or the PayPal credit card. PayPal's uniquely positioned to use the data present at the POS to guide consumers into the optimal payment method whether that be using funds linked to a PayPal or Venmo account or BNPL option.

Moving forward, PayPal will combine BNPL with cashback offers to further drive engagement and awareness on product pages. By PayPal offering promos and rewards tied to BNPL, it stands to further increase the value of its network as PayPal drives consumers to merchants who stand to then generate more sales all while adding incremental volume to the PayPal network.

As PayPal continues to increase the payment options for consumers at the point-of-sale, PayPal is well positioned to continue to capture growth while pushing more consumers to use PayPal to fund their purchase. BNPL is in its early stages, but given PayPal's rise to a top three BNPL provider and the vast amounts of data already being processed by the network, PayPal is destined to remain a leader in BNPL.

The recurring theme for PayPal's AI advantage comes down to its best-in-class data. Because no other payments process has replicated PayPal's unique two-sided payments network, no other company can match the richness of its transaction data. As the AI revolution advances, PayPal will continue finding new ways to feed this rich data into new AI software programs in ways that its competitors can't match.

PayPal Has Plenty of Cash – But Buys the Wrong Things

PayPal's core business is a cash-generating machine, converting 20 cents of every dollar into free cash flow (i.e., the net cash left over for shareholders, after subtracting the cash spent on capital expenditures for maintaining and growing the business).

Since its split from eBay, PayPal's free cash flow has grown from $1.8 billion in 2015 to $5.1 billion in 2022.

But since the spin-off from eBay in 2015, PayPal's management has made a number of aggressive investments into ancillary businesses, with little to show in the way of returns on these investments.

Perhaps inspired by the remarkable success of the Braintree acquisition – which predates current management – PayPal CEO Dan Schulman has been on a $13 billion (and counting) buying spree since his tenure began in 2015. Due to poor levels of disclosure (something we believe will be addressed, as we will discuss), it's difficult to figure out how much value has been created – or destroyed – by these acquisitions. But the signs aren't good.

PayPal's largest acquisition was the 2019 purchase of Honey, a coupon aggregator, for $4 billion. Honey scours the internet for the best discount offers on goods and services from online merchants. Management has yet to report any meaningful details about how the Honey acquisition has boosted transaction volumes or profitability for the business. And it's worth noting that the $4 billion price tag was nearly 6 times the $700 million valuation Honey received on a previous funding round, just one year before the purchase, according to the ***Wall Street Journal***.

PayPal has also made poor internal investments in recent years, including the so-called PayPal "Super App." This app was designed to offer a quasi-banking solution that included dozens of payment functions, including direct deposit, bill pay, and crypto trading, among others. PayPal needed more staff for this project, and its headcount ballooned from 26,500 employees in 2020 to 30,900 in 2021 – the largest increase in its history. This added over $600 million in staffing costs, which would only be justified with a substantial boost in transaction volumes.

The app launched in September 2021 with great fanfare. But it failed to deliver a meaningful increase in growth to offset the broader slowdown in ecommerce as the pandemic boom in online shopping reversed. As a result, PayPal's revenue growth slowed to just 9% in 2022, the lowest since the company's 2015 spin off from eBay.

Meanwhile, the jump in expenses related to the Super App and other growth initiatives created a squeeze on profit margins, which fell from 16.6% in 2021 to 10.4% in 2022, also a record low since PayPal's 2015 IPO.

As a result of PayPal's slowing growth and profit squeeze, investors have rushed for the exits. The launch of the Super App marked the top in PayPal's stock at around $300 before entering into an 80% decline to around $70 today.

Unlike a poor business model, a poor management team is a problem that can be fixed, with a little bit of pressure. And that's exactly the opportunity that one of the world's largest, most successful activist investors has spotted in PayPal.

Activists Push PayPal Back to Basics

In August 2022, activist investment group Elliott Management announced that it had taken a $2 billion stake in PayPal equal to roughly 2% of the company at the time. Led by legendary billionaire investor Paul Singer, Elliott has one of the best track records in the business for unlocking shareholder value through activist pressure.

Since Elliott acquired their stake in PayPal, the company's management has announced a series of strategic shifts that will return focus to the company's core payments business.

This included new commitments from management to pull back from major acquisitions, and significant cost cuts, including 2,000 layoffs (7% of PayPal's workforce) in January 2023.

Management has also committed to returning more cash to shareholders, including a $15 billion buyback program launched in August 2022. And in February of this year, CEO Dan Schulman announced plans to retire by December 2023. We're optimistic that Elliott will help shape a productive new executive team. We're also hopeful that a new management team will bring much needed financial clarity, and accountability, for the operating results of PayPal's myriad business units.

The changes made so far have already improved PayPal's financial results. Since Elliott got involved in Q2 2022, PayPal's quarterly profit margins have increased from a low of 8.1% in Q1 2022 to 13.1% in Q1 2023, even before the full benefit of the workforce reduction kicked in.

With the old management on the way out and continued pressure from Elliot, new leadership could reset the business, clean house, and focus on PayPal's core business.

How PayPal's Capital Efficient Business Could Deliver 20% Annual Returns

The payments business can be highly capital efficient for established companies like PayPal. That's because once the business is running at full scale (i.e., not heavily investing in new infrastructure for rapid growth), the costs are mostly fixed. Since PayPal has already made most of the upfront investment into building its payments network, each dollar of transaction volume requires little to no additional investment, and thus allows for high cash flow generation.

In 2022, PayPal produced $5.1 billion of free cash flow from $27.5 billion in revenue. That's a world-class free cash flow margin of nearly 20%. And because of its high capital efficiency, the business can grow revenues without a big increase in capital expenditures, allowing its free cash flow to outpace revenue growth.

Over the past five years, PayPal's revenue more than doubled from $13.1 billion to $27.5 billion. Over the same period, PayPal's capital expenditures increased only modestly from $667 million to $706 million, a 6% increase. As a result, PayPal's free cash grew by 170% from $1.9 billion to $5.1 billion over the last five years, or compounded growth of 22% per year.

PayPal's business also offers investors an ideal inflation hedge. That's because inflation pushes up the average size of each transaction value, allowing PayPal to earn higher fees without requiring any substantial increase in operating costs or investment to process the higher transaction values.

In the past, PayPal's ample cash flows were misallocated into questionable acquisitions. But going forward, that cash will instead flow to shareholders through repurchases. Based on management's guidance, we expect the company in coming years to return the majority of its free cash flow to investors through share buybacks. That amounts to roughly $5 billion a year today, a number that we expect will meaningfully increase as the company continues growing in the years ahead.

At its current market capitalization of around $65 billion, $5 billion in annual buybacks would reduce PayPal's share count by roughly 8% per year. What's more, PayPal's shares are trading at historically low valuation levels.

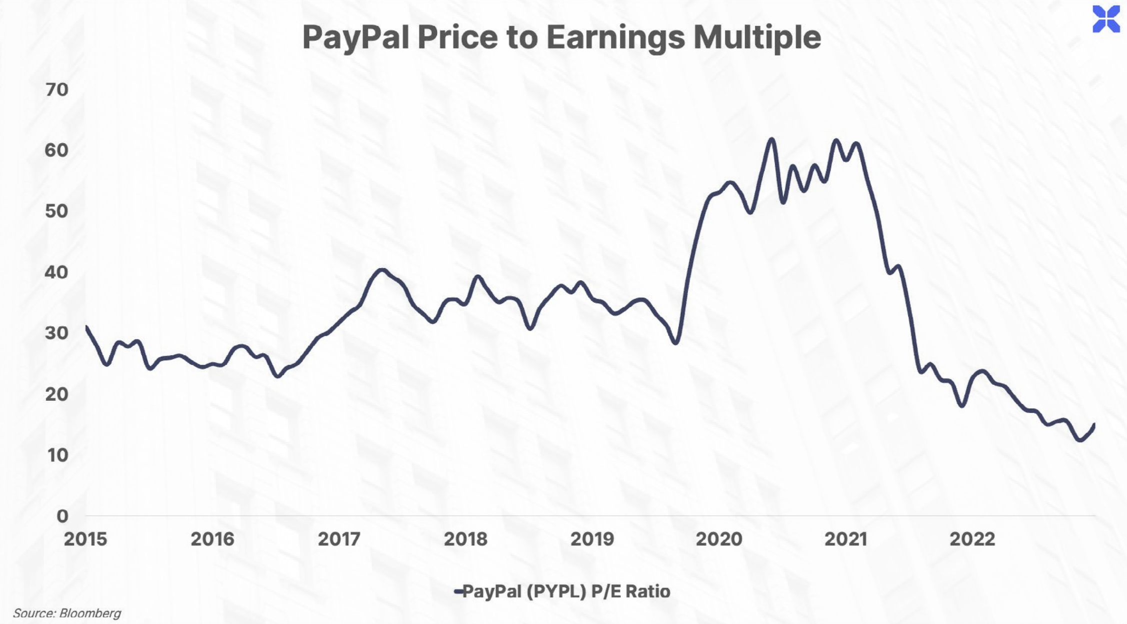
In the first quarter of 2023, PayPal repurchased 19 million shares for a total of $1.4 billion, or roughly 2% of the company's total share count.

Looking ahead, the 6% annual reduction in the share count should translate into 6% annual growth in earnings per share from buybacks alone.

Meanwhile, given the pressure from Elliott Management to cut costs, analysts currently expect PayPal's profit margins to increase to a new record high of 25% in 2024, up from its historic range of 20 - 22%. Given that PayPal has already delivered a consistent improvement in its margins since 2022, before the full impact of its cost-cutting efforts show up, we're optimistic that the company can achieve these profit margins.

Assuming that PayPal's transaction volumes will grow in line with the growth in ecommerce, or by about 8% per year this year, that pencils out to PayPal earning $5 per share in 2023. Given PayPal's capital efficiency, we expect the stock should trade with a 20x earnings multiple (a slight premium versus the S&P 500 at 19x).

20x earnings is a conservative estimate for PayPal's multiple compared with its historic range of 25 - 40, before the COVID-driven boom and subsequent collapse from 2020 - 2022:



Twenty times $5 in earnings per share puts our near-term upside case for PayPal at $100 by the start of 2024 (when full year 2023 earnings are reported), or nearly 40% upside from its 2023 price of $73.

From there, based on our expectations for 7 - 9% annual earnings growth, and a 6% annual reduction in the share count, that translates into compounded returns of 13 - 15%. Factoring in the initial 40% gains, and assuming a 5-year holding period, that translates into compounded returns exceeding 20%. Meanwhile, as long as today's high interest rate environment prevails, PayPal could benefit from further near-term upside from higher yields on its $23 billion investment portfolio.

PayPal's AI investments could add further upside by helping cut fat from its bloated staff. In the past, PayPal relied on software engineers to manage many of these processes and services. Now, AI promises to offload a substantial portion of PayPal's software workload, unlocking higher capital efficiency for the business.

On the company's Q2 2023 earnings call, PayPal management reported a 20% - 40% increase in engineering productivity from adding AI tools into its software-development efforts. The potential productivity boost from AI could drive a meaningful increase in PayPal's profitability by cutting costs from its highest expense item: high-priced engineering staff.

However, we note that PayPal, like all payment processors, will likely suffer a decline in payment volumes in the event of a recession. But given PayPal's starting valuation near all-time lows, and assuming the business continues on its current trajectory towards improving profitability, this investment should come with a reasonable margin of safety.

The biggest long-term risk to PayPal could come from deep-pocketed competitors, namely Apple, replicating the same kind of full-fledged payments ecosystem that currently separates PayPal from its peers. While that scenario remains unlikely in the short term, it's a risk that could grow as Apple (and others) continue making investments into their payment networks over time.

Plus, there's also the near-term risk associated with the ongoing shakeup of PayPal's management team. As discussed earlier, current CEO Dan Schulman has announced plans to retire by year-end, but the new leadership remains a big question mark. While we're optimistic that activist involvement from Elliott will help ensure PayPal's new CEO will act as a good steward of shareholder capital, this remains an unknown risk today.

We recommend that readers watch PYPL closely for further developments.

Action to Take: For the latest updates on our open positions, please visit our live portfolio **here.**