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THE BIG SECRET ON WALL STREET

Elon's Original Money Machine Reboots

- This Classic Fintech Disruptor Could Deliver 20% Annual Returns
- Activists Intervene to Get This Competitive Business Back on Track

FROM THE DESK OF PORTER STANSBERRY

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"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 or Ford.

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 the early 2000s, online auction site eBay was one of the most successful ecommerce sites in the world. In 2000, eBay had over 12 million users with 4.5 million items available for sale, making it the largest online commerce website in the world.

But until eBay bought PayPal, its users could only pay with checks and money orders, delivered through 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 ecommerce 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 back 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.

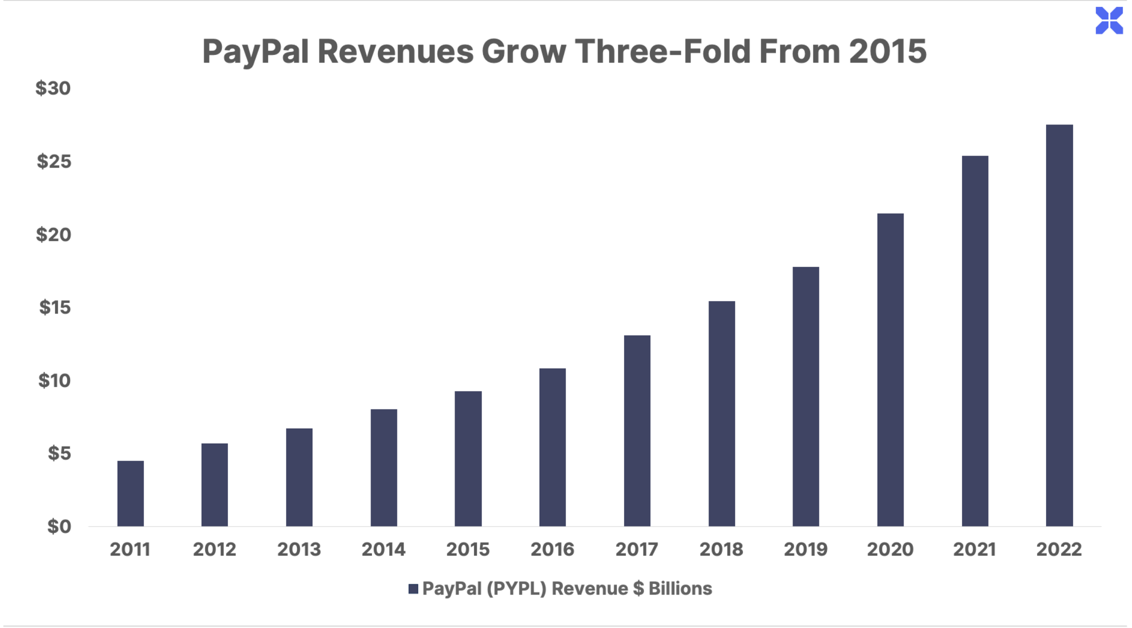
And that spelled opportunity for legendary investor and corporate activist Carl Icahn.

In February 2014, after buying 46 million shares of eBay, or 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 eBay's 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 last year:



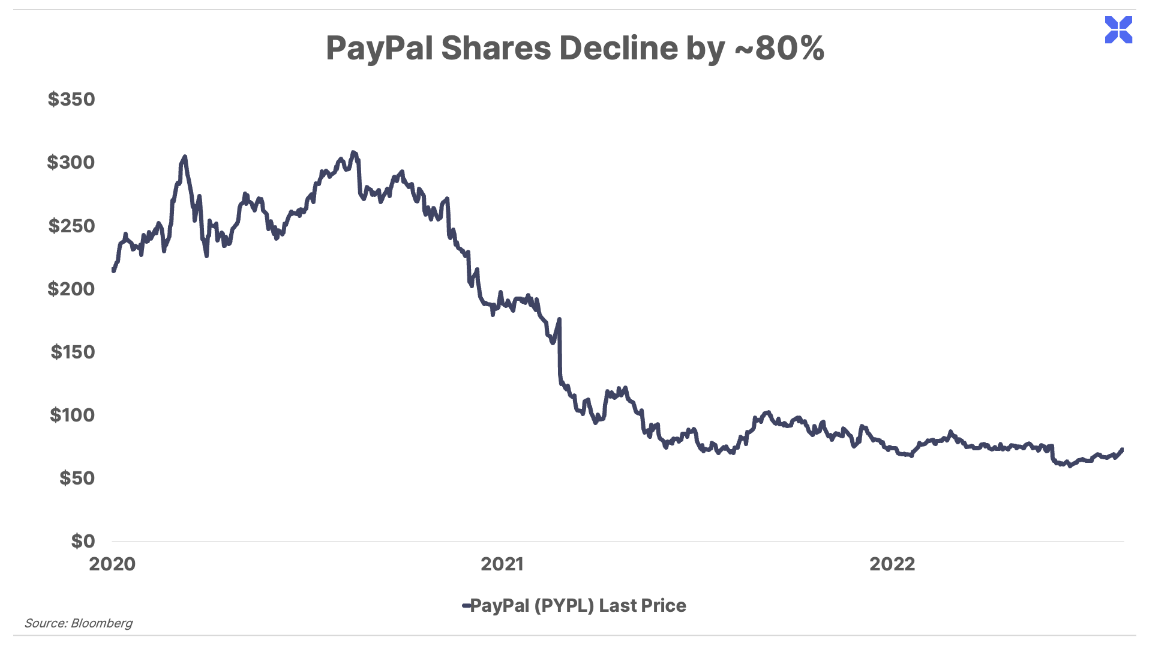
Today, PayPal is one of the world's largest digital payment networks, with 435 million users around the world. This includes 400 million consumer accounts and 35 million merchant accounts.

The business tends to grow in line with the overall growth in ecommerce transactions. That meant that PayPal was a COVID-era winner, as consumers trapped at home spent their stimulus checks online. PayPal's revenues grew by 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 ecommerce 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 competitors that have entered the digital payments arena in recent years, 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 $70 today.



Despite these recent stumbles, PayPal's core payments business is a highly capital efficient, world-class asset with an enduring competitive moat. And now, management is aggressively cutting costs and committed to returning 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 more than 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, at just over 14x earnings (and a substantial discount to the S&P 500's 19x earnings multiple).

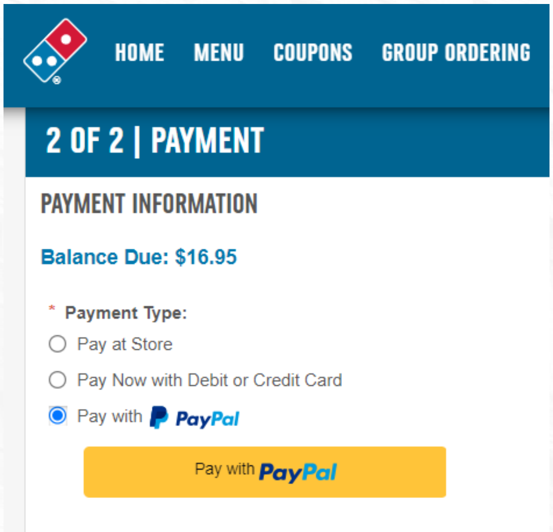
Let's begin with an overview of PayPal's business.

Simple Business, Complex Transactions

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

But not all transactions are created equal. PayPal processes a myriad of different payment types, each with its own unique economics. These 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 among other online merchants in the late 1990s and early 2000s. Today, the PayPal button can be found in the online checkout menu for millions of online merchants, large and small:



For transactions made through the PayPal button, merchants pay a fixed $0.49 plus 3.49% of the transaction value. For a $100 purchase, for example, that amounts to just under $4. These are the highest take rates PayPal earns across its business.

The key feature of these payments is that they occur inside of PayPal's network, which means that consumers and merchants transact directly through their PayPal accounts. That allows PayPal to keep all or a majority of the transaction fee (depending on the type of payment), which makes branded payments the company's most profitable earnings stream.

We estimate that branded payments through the PayPal button make up roughly 30% of the company's total transaction volumes, or about $400 billion last year. And because of the high take rates in this segment, branded payments generate a much larger percentage of the company's profits (we estimate around 40%). (PayPal management is notoriously opaque about the company's individual business segments, a topic we revisit later.)

While branded payments generate the highest profit margins, the size of this market is limited to the users within PayPal's network. Over the last decade, PayPal began expanding beyond branded payments in order to tap into the much bigger market for digital transactions outside of its network.

Beyond the Button

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.

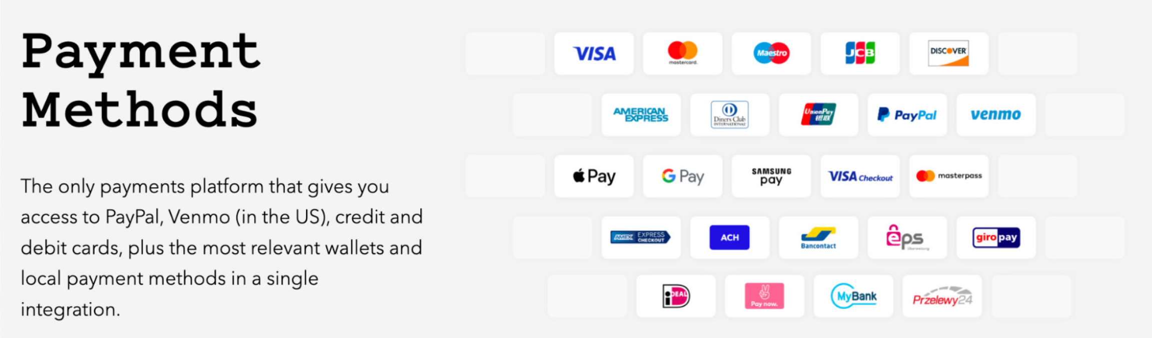
In 2013, PayPal acquired Braintree for $800 million in order to begin offering unbranded payments to merchants. Braintree is what's known as a "full stack payment processor." This means that it powers the entire customer buying process, including building the checkout page, verifying customer identities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

By offering this full suite of payment technology, full stack payment processors like Braintree allow merchants to efficiently manage all of their payment options from one platform.

Braintree processes these unbranded transactions through third-party payment networks, like credit card companies – so it shares the transaction fee with them. As a result, the fees Braintree earns on unbranded payments are lower than those made through the PayPal button, at $0.49 plus 2.59% of the value of the transaction.

Braintree has become a major driver of PayPal's business by tapping into the much larger market for unbranded payment volumes. Braintree has grown its payment volumes from virtually nothing in 2013 to $400 billion in 2022, meaning it reached the same volume of payments in 10 years that took the PayPal button 25 years to achieve.

Braintree achieved this growth by adding a lot of value to merchants along the way. According to Kelton Research, a consumer insights consulting agency, 78% of consumers are more likely to make an online purchase if they see the logo of their preferred payment type. Braintree allows merchants to accept more than 25 different payment methods (and in 130 different local currencies) ranging from traditional debt/credit cards, like Visa and MasterCard, to digital payment providers like PayPal and Apple Pay, among others:



Braintree processes some of the most complex transactions on the internet – for instance, payments for online vacation rental platform AirBnB, which has partnered with Braintree since 2010.

When a consumer books an AirBnB rental, the payment is split and distributed to several recipients, and at different times. This includes a payment to the homeowner, a listing fee to AirBnB, cleaning fees that may go to a third-party contractor, and fees to as many as several different tax collection entities. Also, the deposit must be held in escrow until the rental is over, when it's returned to the guest, or a portion of it is sent to the homeowner to compensate for damages or additional cleaning fees. Braintree's full stack payments processor enables merchants to customize the flow of funds so that the appropriate parties receive payment once the customer's visit is over.

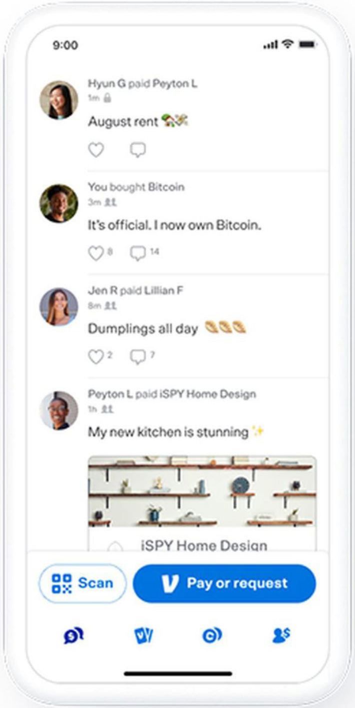
Even after growing into one of the top unbranded digital payment processors over the last decade, Braintree's transaction volumes are still growing at roughly 40% per year.

Braintree has been PayPal's most successful acquisition to date by a wide margin. That's partly because the Braintree purchase came with a hidden gem built in… one of Braintree's own prior acquisitions, a peer-to-peer payment provider called Venmo.

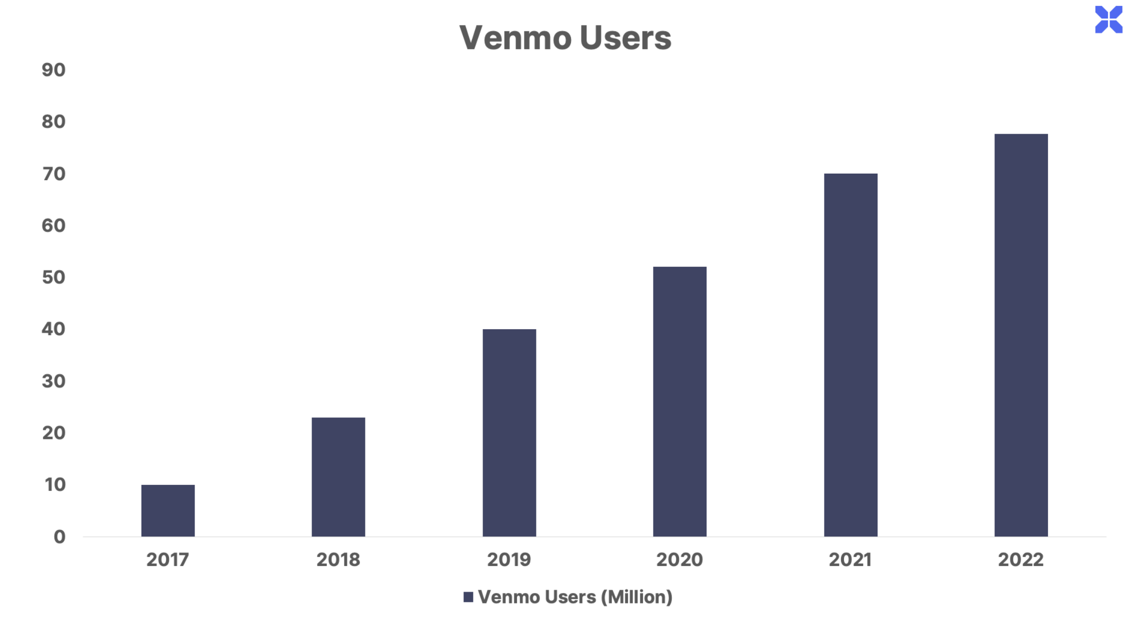
Venmo's Growth Goes Viral

Venmo began as an app for sending money between friends. It was initially popular among college students looking to split the rent check or the cost of their Domino's order.

The app included a social element that allowed users to publicly post their transactions, along with messages – kind of like a Twitter feed for money transfers.



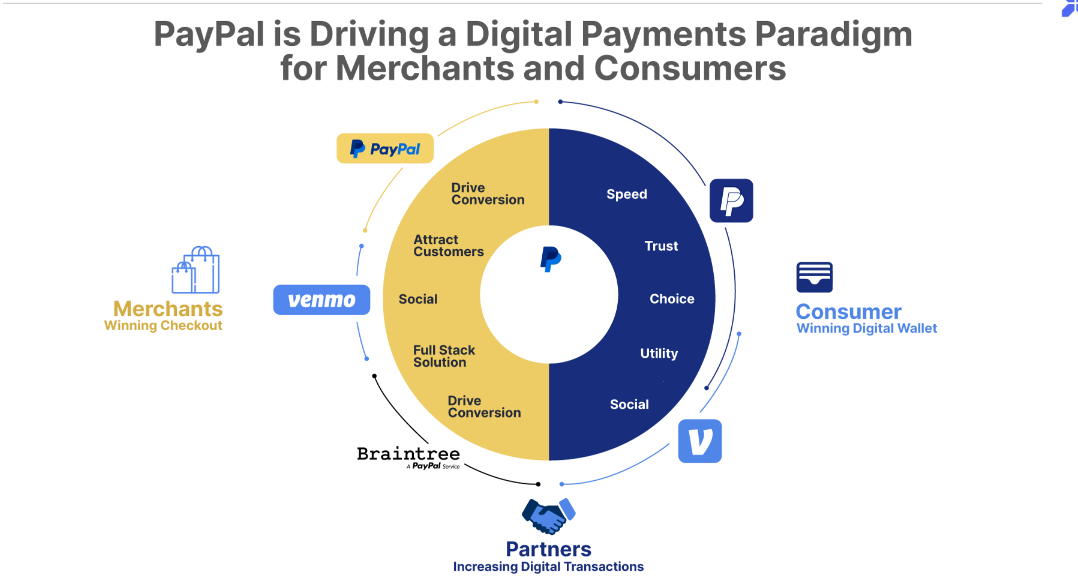
When PayPal acquired Braintree in 2013, Venmo was a niche app. But it grew over time, and today, Venmo has roughly 90 million active accounts – nearly the same number PayPal had across its entire business when it split from eBay in 2015. And it's become a key driver of PayPal's network growth in recent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



Most transactions through Venmo today are free peer-to-peer transfers that don't generate any fees for PayPal. This free money transfer feature attracts users. In recent years, PayPal has begun monetizing these users by pulling them into PayPal's branded payment network. And it's all made possible thanks to the power of Braintree's full stack processing capabilities.

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.

PayPal’s Unmatched Payments Ecosystem



Source: PayPal Investor Relations

Before PayPal bought Venmo and Braintree, when Venmo users received cash from a peer-to-peer transfer, they would typically just transfer that cash into their linked bank account. This limited Venmo to mostly earning tiny margins on certain types of transfers or withdrawals.

But now that PayPal owns Venmo, this has opened up the opportunity for PayPal to offer Venmo users special deals and promotions from its network of merchants. This encourages Venmo users to spend their cash with PayPal’s merchants, instead of withdrawing it.

PayPal is becoming increasingly sophisticated at encouraging these transactions, including the development of pop-up screens when users log in that offer instant, one-click purchases. PayPal also targets Venmo users with specific offers based on their transaction histories. Users that frequently transfer money to friends for splitting up a food bill, for example, may be highly receptive to offerings from local restaurants or food delivery services.

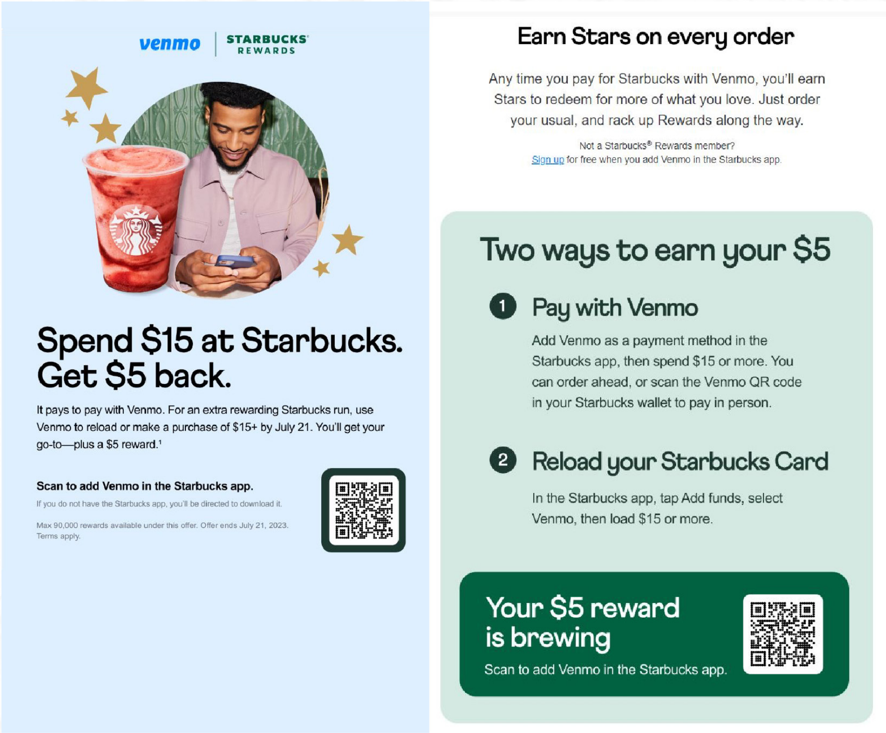
Braintree provides the technology that allows Venmo to integrate its user base with PayPal’s merchants to process these payments. And because Braintree processes Venmo purchases through PayPal’s branded payments network, PayPal captures high profit margins on these transactions.

Because PayPal earns high transaction fees on Venmo purchases, it can afford to offer generous rewards to its users, like 20 - 30% cash back offers, which are some of the highest rates in the payments industry.

Braintree also works with merchants in the Venmo/PayPal ecosystem to handle unique discounts, loyalty rewards, and other benefits designed to drive more engagement and more sales for merchants.

Consider the following real-world example. One of the analysts researching this report is an avid coffee drinker and Venmo user. On Tuesday of this week, he received the following Venmo promotion of a $5 reward for a $15 Starbucks transaction.

Note that Venmo offers the consumer two choices to earn this reward: either by paying with Venmo, or by reloading their Starbucks Card (while also offering an easy-to-use QR code for downloading the Starbucks Card app if users don't already have one):



Venmo offers merchants like Starbucks value by tapping into its user base of 90 million consumers. And merchants can benefit from Venmo's user data to specifically target consumers who are likely to be coffee addicts (including yours truly). Braintree offers the technical prowess to create customized promotions, like integrating the Starbucks rewards card into the check-out option.

And finally, PayPal's high profit margins on branded payments means it can afford to pay $5 rewards on a $15 purchase (a 33% ROI, an offer any financial analyst would be foolish to refuse). This, in turn, keeps engagement high and encourages users to transact more on Venmo.

PayPal's unique combination of high-margin branded checkout, a fast-growing user base from Venmo, and sophisticated payments processing from Braintree has created an unparalleled payments ecosystem that separates it from the competition. That's how PayPal has maintained its growth, despite a growing list of new entrants vying for market share in recent years.

Big Tech Comes for the PayPal Button

PayPal earns some of the highest transaction fees in the industry from its branded PayPal button payments. In the "your margin is my opportunity" spirit, big tech companies have entered the lucrative payment button market. Apple Pay, Google Pay, Amazon Pay, and Samsung Pay, among others, have introduced digital wallets.

A digital wallet allows consumers to upload and store multiple different funding sources, like credit/debit cards or a linked bank account, into a secure payments network. When consumers make purchases through their wallet, this enables seamless online transactions, without the need to input their payment information for each purchase. Digital wallets also keep payment information stored within the network and thus avoids the risks of transmitting credit card information across the internet, for example.

Confinity, the predecessor to PayPal, created one of the first digital wallets in the late 1990s. While PayPal secured an early lead, it's no longer the only game in town. The fiercest competition by far has come from Apple Pay, which Apple launched in 2014. In the same way that eBay's large user base accelerated PayPal's growth in the early 2000s, Apple has benefited from its massive installed base of 1.5 billion iPhone users to jumpstart the adoption of Apple Pay.

The number of Apple Pay users grew to 536 million by year-end 2022, surpassing PayPal's 435 million user base. This prompted a growing chorus of investors proclaiming the end of PayPal's growth and dominance in branded payments. This was part of the negative sentiment that pushed PayPal's share price down towards multi-year lows below $70 per share in 2022.

But the market is wrong about this… in a big way.

Apple fans may gravitate towards Apple Pay, but merchants ultimately pay for each transaction – and merchants find PayPal a more valuable partner to work with.

According to a recent analysis by Morgan Stanley, 83% of the largest 475 global ecommerce merchants accept PayPal, compared with just 48% for Apple Pay. That makes PayPal the undisputed leader in merchant adoption for digital payments, with Apple Pay a distant second.

Apple Pay suffers from the same disadvantage as the other digital wallet newcomers: the lack of a full payments ecosystem.

While the consumer experience is similar, behind the scenes the Apple Wallet is really just an extension of the traditional card networks, and this matters...

When an Apple Pay user uploads their credit/debit card or bank information into their Apple Wallet, and then pays with their Apple Wallet at checkout, the payment flows through the same traditional card and bank networks that have been in existence since the 1960s. The only difference is that Apple charges an additional 15 basis points (0.15%) as commission.

In contrast, PayPal's network connects merchants directly with consumers, where PayPal can process transactions directly between the merchant and consumer. Here's how this impacts the merchant side of the equation...

Since Apple shares transaction fees with credit cards and the banks, it earns miniscule profit margins on each Apple Pay transaction, compared to the margins that PayPal earns with its branded payment button. As a result of these lower fees, Apple can't afford to offer the same kind of generous rewards that PayPal (and Venmo) users get access to. Fewer rewards means less business for merchants, and thus less reason to do business through Apple Pay.

Then, there's the data side of the equation. Because card networks like Visa and Mastercard process each Apple Pay transaction, they retain transaction data on the merchant side of the equation. As a result, Apple Pay cannot match the precision of PayPal's targeted marketing promotions, which lowers the value of the promotions Apple Pay can provide for merchants.

Finally, because Apple lacks the full stack processing power of Braintree, Apple Pay can't deliver the types of customized payments and rewards programs that Braintree can...

It's no surprise that many consumers gravitate to Apple Pay. After all, the user experience is seamless for millions of iPhone users. But it's only through the lens of the full payments ecosystem, including the critical merchant side of the equation, that PayPal's true advantage over competitors like Apple Pay becomes clear.

Even as more consumers have adopted Apple Pay, it takes two sides to make a transaction (i.e. consumers and merchants). And if fewer merchants choose Apple Pay, Apple Pay's ability to take market share from PayPal will be limited.

Only if Apple Pay replicates PayPal's full ecosystem, and begins offering a competitive value proposition for merchants, should PayPal investors begin worrying about disruption. For now, that outcome appears nowhere in sight. That means PayPal remains one of the leaders in branded checkout, despite the rise of Apple Pay, its top competitor in this segment.

Meanwhile, PayPal's unmatched payments ecosystem also gives it a critical edge against its other rivals in unbranded checkout, which offer full stack payment solutions.

PayPal's Full Stack Competition

Braintree's key competitors in unbranded payments include Dutch firm Adyen (OTC: ADYEY) and privately held Stripe. Both companies are about twice the size of Braintree, processing roughly $800 billion in transaction volumes last year.

Adyen specializes in offering payment solutions to mid-to-large sized businesses, and it also processes international payments. Stripe targets startups and other small merchants.

Braintree is closing in on the competition. Based on third-party research and commentary from PayPal's management on recent earnings calls, Braintree grew at somewhere between 40 - 50% in 2022. That compares with 26% growth for Stripe, and 33% growth in Adyen (after adjusting for currency fluctuations) in 2022.

When PayPal first acquired Braintree in 2013, Braintree didn't yet have full stack processing capabilities. It was limited to only processing payments through the traditional credit card networks, and thus lagged behind Adyen and Stripe, which already offered full stack payments at the time.

In 2014, Braintree began offering full stack payments. This accelerated its growth from $12 billion in payment volumes in 2013 to $50 billion in 2015, and to more than $400 billion by 2022. Despite starting late, Braintree now offers formidable competition for the current leaders in unbranded payments, Adyen and Stripe.

Braintree's key advantages come from being part of PayPal's network. As mentioned earlier, merchants can generate more sales when payment providers offer the widest selection of payment options. Stripe and Adyen can only process payments from third parties. Braintree, on the other hand, offers merchants a unique proposition: the ability to accept both unbranded transactions from third-parties, as well as the branded PayPal button.

The PayPal button is a big draw for merchants around the world, because it helps increase their sales. According to a survey by Enterprise Apps Today, when online merchants offer the PayPal button at checkout, consumers are 54% more willing to make the transaction compared to when PayPal is not offered as a payment option. This is a result of PayPal's 25-year history as a trusted payment provider.

Braintree gets to ride PayPal's coattails. Braintree is the only payment processor in the world that offers a full menu of unbranded payment options, plus the coveted PayPal button.

But that's not the only way Braintree benefits from PayPal's leading position as a leader in digital payments.

The Leader in Fraud Detection

Payment fraud is one of the biggest costs of doing business online. And when a fraudulent transaction occurs, it's the merchant that foots the bill.

That's why merchants place a big emphasis on fraud fighting capabilities when selecting payment providers, as payment processors are the first (and often the only) line of defense.

But fighting fraud is a delicate balance. Payment processors might succeed in limiting fraudulent transactions by being too conservative. As a result, they might end up blocking a large number of legitimate transactions. When payment providers mistakenly label legitimate transactions as fraud, merchants lose sales.

So merchants measure payment providers on two key metrics: the percent of fraudulent transactions and the payment "approval rate", which refers to the number of legitimate payments that get processed. PayPal consistently leads the industry in both metrics.

The secret to PayPal's fraud-fighting prowess lies in its unmatched data set of past customer transactions. Transaction history is the best indicator of whether a current transaction is fraudulent – and PayPal has the longest history of transaction data to inform its fraud detection algorithms.

Here again, PayPal's advantage in fraud prevention gets passed on to Braintree. As the only full stack payment processor that can tap into PayPal's best-in-class fraud fighting systems, Braintree is ahead of its rivals. That's a big reason why Braintree has begun taking market share from Stripe and Adyen.

Last but not least, Braintree offers merchants access to PayPal's network of 400 million 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 – lacking this full ecosystem – can't.

The Power of the Incumbent

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.

Even though competitors Apple Pay, Adyen and Stripe have grown rapidly over the last 5 - 10 years, the numbers reveal that PayPal's growth trajectory and market share remain intact.

Transaction volumes have grown from $288 billion at the time of the split from eBay to $1.4 trillion today. While transaction growth has slowed as the pandemic boom in ecommerce faded starting in 2022, PayPal continues growing in line with the overall growth rate in ecommerce, currently at 7 - 9% per year.

Meanwhile, the other key measure of the strength of PayPal's network is reflected in engagement, measured by the average number of user transactions each year. When PayPal first split from eBay, an average PayPal user made 21 transactions per year. Engagement has steadily increased over time, and today is at a record high of 53 average transactions per year.

PayPal's ability to consistently add more users into its network, while growing their engagement, is a testament to its enduring competitive advantages. And until competitors can overcome these advantages, we expect PayPal will continue growing in line with the increase in ecommerce transactions for the foreseeable future.

However, the key for translating this growth into profitability and shareholder returns will require significant changes by PayPal's management.

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 last year.

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, 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. Meanwhile, in addition to improving its profitability from cost cuts, PayPal is a big winner of today's higher interest rate environment.

PayPal's 10-Figure Windfall from Higher Interest Rates

One area where PayPal's management team has done well has been on maintaining a pristine balance sheet. And their savvy balance sheet management has positioned the company to reap a windfall from the Fed's rate hiking campaign.

As of the end of Q1 2023, PayPal had $11.1 billion in debt versus $10.6 billion in cash and cash-equivalents (i.e., short-term Treasuries), making its net debt almost zero.

The debt on PayPal's balance sheet was issued at ultra-low interest rates, with an average interest rate of roughly 3%. And the debt maturities (i.e., the date at which the bonds must be repaid) stretch out to as far as the 2050s. The average maturity across all of PayPal's outstanding debt is 2032, and PayPal's ample cash flow will allow the company to easily repay these bonds as they come due.

The company's annual interest expense on its debt is roughly $330 million per year. Before 2022, with short-term interest rates stuck near zero, PayPal earned almost nothing on its cash. In 2021, for example, PayPal earned just $57 million in interest income.

Today, however, PayPal can safely invest its $10.6 billion cash pile into short-term Treasuries (i.e., one year or less in maturity) that yield over 5%. That translates into an extra roughly $500 million in profits that flow straight to the bottom line, without any additional operating expense.

There's another hidden benefit from higher interest rates inside of PayPal's balance sheet, in the form of roughly $36 billion in customer deposits. These are deposits that sit on PayPal's balance sheet between the time when customers deposit or receive cash into their account, versus when they withdraw or spend.

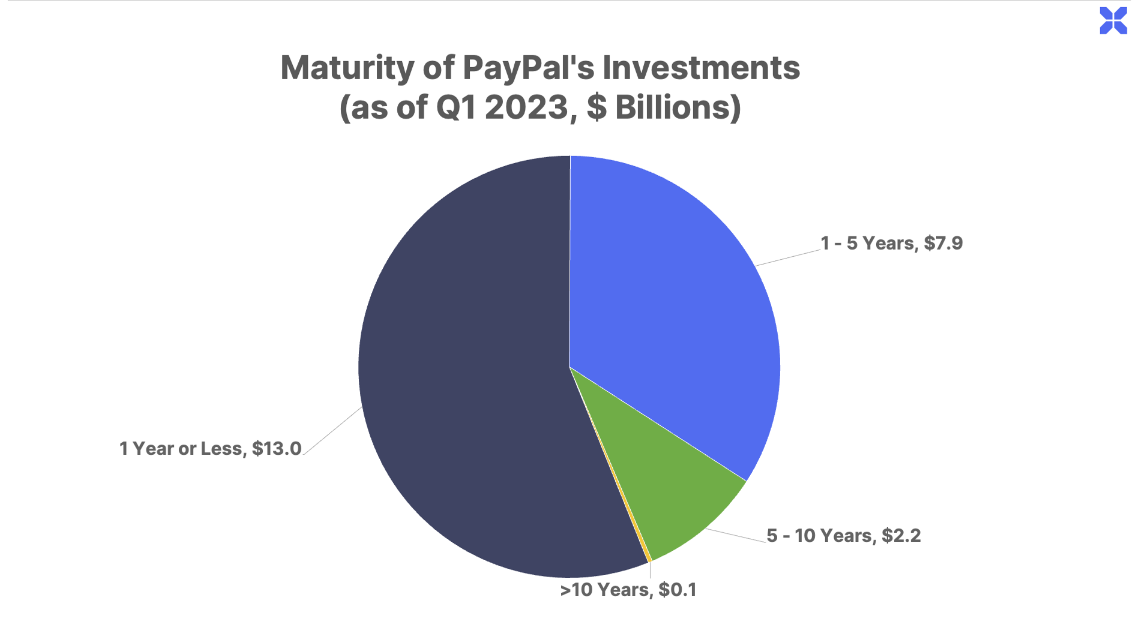
The average length of time that these deposits sit idle on PayPal's balance sheet is between 9 - 12 months. In the meantime, PayPal can invest these deposits into safe, high-quality investments like Treasuries, in the same way that banks can invest customer deposits to generate income.

Importantly, PayPal is not exposed to the same type of "deposit flight" risk that took down Silicon Valley Bank and others earlier this year. As we wrote about previously, Silicon Valley Bank invested customer deposits in "long duration" bonds, which plunged in value as interest rates rose. When customers rushed to withdraw their money, the bank was forced to liquidate these bonds at a substantial loss, rendering the bank insolvent.

PayPal avoids this risk by a) keeping a substantial portion of customer deposits in cash and b) investing the rest into short-duration instruments that can easily be sold without taking a substantial loss, should the need arise.

The company doesn't disclose what percentage of customer deposits it invests into cash versus income-generating assets. But as of Q1 2023, PayPal's total investment portfolio was valued at $23.1 billion. Assuming roughly $10 billion is from PayPal's corporate cash balance, that implies about $13 billion of customer deposits have been invested, or about one-third of the total.

Over half of PayPal's portfolio has a maturity of one year or less, with 90% maturing in 5 years or less, as shown below:



PayPal stress tests its portfolio for higher interest rates. In its latest financial report, in Q1 2023, the company reported that a 1% increase in interest rates would translate into a $153 million loss on its existing portfolio, or a decline in value of less than 1%. Importantly, PayPal will only realize these losses if it needs to sell bonds to meet a flood of redemptions that it can't meet with cash on hand. While we view this scenario as unlikely, PayPal's portfolio wouldn't take a substantial hit should it occur.

The full impact of higher interest rates will take time to show up in PayPal's financials, as its existing portfolio of low-yielding bonds matures, and allows for the reinvestment of the proceeds into today's higher rates. But the process is already underway. In Q1 2023, PayPal's interest income surged to $108 million, up from just $15 million in Q1 2022.

Looking ahead, PayPal is poised for a 10-figure windfall if interest rates simply remain flat from here. By Q1 2024, assuming PayPal reinvests its $13 billion portfolio of short-term bonds into 3-month Treasuries at current rates of 5.4%, the company could be earning over $1 billion in annual interest income. And if Jamie Dimon is correct in advising his clients and other banks to "be prepared for 6% - 7%" interest rates, the upside is to $1.5 billion or more.

This opportunity for $1 billion - $1.5 billion in interest income alone represents a roughly 20 - 30% boost to free cash flow over 2022 levels.

PayPal is one of the few business models that offers investors upside from both higher interest rates, and higher inflation.

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.

Last year, 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 $80 billion, $5 billion in annual buybacks would reduce PayPal's share count by 6% per year. What's more, PayPal's shares are trading at historically low valuation levels.

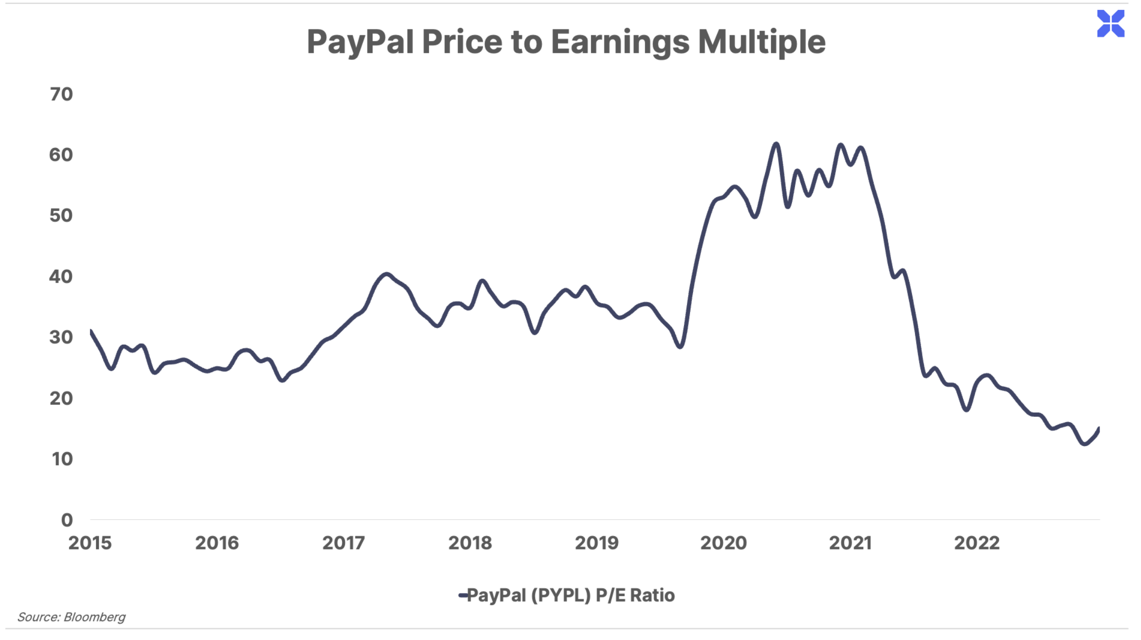
In the first quarter, PayPal repurchased 19 million shares for a total of $1.4 billion, or roughly 2% of the company's total share count.

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 2023 and 2024, up from its historic range of 20 - 22%. Given that PayPal has already delivered a consistent improvement in its margins over the last year, 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 current price of $72.

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.

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.

For these reasons, we're assigning a risk rating of 3 for PayPal.

Action to Take: Buy PayPal (PYPL) under $90 per share.

New to the Porter & Co. Portfolio? Start With Our Top 3 "Best Buys" Today

Our goal at Porter & Co. is to bring you world-class investment research, focused on "inevitable" businesses that you can buy and hold forever. This is the surest and safest path to building permanent wealth.

While we don't believe in timing the market, we do keep a constant eye out for bargains. In each edition of *The Big Secret*, we highlight three current portfolio picks that are at an attractive buy point. In addition to today's recommendations, we suggest you focus on these:

1. Dirty energy is never going away... Instead, it will just take safer, cleaner forms, like nuclear energy. **BWX Technologies (BWXT)** is A Matter of National Security, and a bargain at 18x enterprise value (i.e., the combined value of equity and debt) to operating income. BWXT has been a leading manufacturer of nuclear reactors and components since the birth of the nuclear power industry over 100 years ago. BWXT is responsible for powering the Navy's submarines and aircraft carriers as well as all the mechanical equipment in the engine room. The company's recession-proof business with the U.S. government is based on long-term contracts that provide a high degree of cash flow stability and predictability. It's also pioneering a revolutionary "bring-your-own-energy" concept for the commercial sector: small modular nuclear reactors (SMRs). These portable reactors could rip up the playbook of energy as we know it today, making nuclear energy a safe, cheap and sustainable global energy source.

2. **Credit Acceptance Corp (CACC)** is a leading subprime auto lender, which we call the Goldman Sachs of White Trash. The business of making subprime loans isn't glamorous, but it's tremendously profitable and highly capital efficient. CACC has generated 68% free cash flow margins over the last three years, and today trades at just 17x earnings. (It's at a buy point of $554 per share, or less than 18x earnings.) Shares have recently sold off on fears of a subprime auto lending meltdown, but as we explained in a recent portfolio update, CACC is uniquely positioned to benefit from spiking default rates – and that's already showing up in its latest quarterly earnings report. With lending standards tightening and auto delinquencies on the rise, more consumers are entering the subprime category. This was confirmed last quarter as CACC's loan growth surged by 26%.

3. **Viper Energy Partners (VNOM)** is an oil and gas royalty company – the best business in the energy sector, and the Secret Behind T. Boone's Fortune. Unlike oil and gas producers, VNOM never spends a dime searching for oil or

drilling holes deep into the earth. It simply owns the land upon which other companies drill, and collects a percentage of the cash flow. That makes it one of most capital efficient businesses you'll find anywhere, with 80% free cash flow margins. VNOM funnels its profits directly to shareholders, instead of back into the ground. VNOM currently trades at a 16% free cash flow yield – the best valuation since the depths of the COVID-19 pandemic. The company is returning capital to shareholders through a 5.2% dividend yield and a repurchase program that has reduced outstanding units by 10% over the last 18 months.

Portfolio Update

The Big Secret on Wall Street PORTFOLIO

ENERGY & COMMODITIES	Ticker	Description	Purchase Date	Cost Basis	Closing Price	Yield	Income Received	Total Return	Status	Risk Rating (1 - 5)
EQT CORPORATION	EQT	U.S. Gas-Focused E&P	06-03-2022	$47.99	$40.82	1.25%	$0.60	-13.69%	Buy Under $50	4
TELLURIAN INC.	TELL	U.S. LNG Exporter	06-17-2022	$3.53	$1.59	0.00%	$0.00	-54.96%	Buy Under $5	5
VIPER ENERGY	VNOM	Oil and Gas Royalty	09-02-2022	$30.58	$25.80	5.12%	$1.31	-11.35%	Buy Under $34	3
BWX TECHNOLOGIES, INC.	BWXT	Nuclear Power Equipment	12-23-2022	$58.24	$70.35	1.25%	$0.46	21.58%	Buy Under $80	3
BLACK STONE MINERALS	BSM	Oil and Gas Royalty	02-17-2023	$15.90	$16.71	11.49%	$0.48	8.08%	Buy Under $18	2
AMERIGO RESOURCES	ARREF	Base Metals	03-31-2023	$1.21	$1.18	6.78%	$0.02	-0.83%	Buy Under $1.35	4
BITCOIN	BTCUSD	Cryptocurrency	05-12-2023	$27,179.90	$29,741.10	0.00%	$0.00	9.42%	Buy Under $35,000	4
PEABODY ENERGY	BTU	Coal Mining	06-23-2023	$20.69	$21.88	1.37%	$0.00	5.75%	Buy Under $25	4
BATTLESHIP STOCKS										
ALTRIA	MO	Tobacco Maker	07-15-2022	$42.24	$45.66	8.23%	$3.76	17.00%	Buy Under $50	1
PHILIP MORRIS	PM	Tobacco Maker	07-15-2022	$90.18	$98.18	5.17%	$5.08	14.50%	Buy Under $100	1
CREDIT ACCEPTANCE CORP	CACC	Consumer Finance	07-29-2022	$575.91	$554.67	0.00%	$0.00	-3.69%	Buy Under $600	3
NOVO NORDISK	NVO	Pharmaceuticals	10-28-2022	$106.67	$164.48	2.13%	$1.19	55.31%	Hold	2
WINMARK CORPORATION	WINA	Specialty Apparel Stores	09-16-2022	$218.96	$368.18	0.87%	$5.30	70.57%	Hold	1
ACTIVISION BLIZZARD	ATVI	Video Games	03-03-2023	$77.71	$92.29	0.00%	$0.00	18.76%	Closed	2
DOMINO'S PIZZAS INC	DPZ	Restaurants	02-27-2023	$300.00	$387.83	1.13%	$1.21	29.68%	Hold	3
DREAM FINDERS HOMES, INC.	DFH	Homebuilder	04-28-2023	$14.83	$25.14	0.00%	$0.00	69.52%	Buy Under $30	4
FRANCO-NEVADA CORP	FNV	Precious Metals Streamer	05-12-2023	$154.74	$146.81	0.93%	$0.34	-4.91%	Buy Under $170	2
ALTISOURCE ASSET MANAGEMENT	AAMC	Asset Management	07-07-2023	$58.00	$49.20	0.00%	$0.00	-15.17%	Buy Under $70	5
PAYPAL	PYPL	Payment Processor	07-21-2023	$73.02	$73.02	0.00%	$0.00		Buy Under $90	3
INCOME & DISTRESSED DEBT										
MICROSTRATEGY INC	CUSIP: 594972AC5	2025 Convertible Bond	10-14-2022	$758.00	$1,280.05	0.59%	$7.50	69.86%	Hold	4
QURATE RETAIL, INC.	QRTEP	8% Cumulative Preferred Stock	01-20-2023	$40.64	$35.10	22.79%	$4.00	-3.79%	Buy Under $50	3
ANNALY CAPITAL MANAGEMENT	NLY	Real Estate Investment Trust	02-03-2023	$23.75	$20.19	17.43%	$0.65	-12.25%	Buy Under $24	2
SABA CAPITAL & INCOME OPPORTUNITIES FUND	BRW	High Yield Bond Fund	03-17-2023	$8.07	$7.81	13.67%	$0.26	0.01%	Buy Under $9	3
OAKTREE SPECIALTY LENDING CORP	OCSL	Specialty Investments	03-31-2023	$18.57	$20.13	10.93%	$0.55	11.36%	Buy Under $22	2
Property & Casualty Insurance										
W.R. BERKLEY	WRB	P&C Insurance	05-26-2023	$56.10	$61.64	0.65%	$0.00	9.88%	Buy Under $62	2
PROGRESSIVE CORPORATION	PGR	P&C Insurance	06-09-2023	$131.08	$123.96	0.32%	$0.10	-5.36%	Buy Under $160	2
CHUBB LIMITED	CB	P&C Insurance	06-09-2023	$191.63	$199.39	0.20%	$0.86	4.50%	Buy Under $220	2
SKYWARD SPECIALTY	SKWD	P&C Insurance	06-17-2023	$24.66	$24.63	0.00%	$0.00	-0.12%	Buy Under $35	2
BETTER THAN THE MARKET										
CAMBRIA SHAREHOLDER YIELD	SYLD	Yield Focused ETF	01-06-2023	$61.22	$63.25	2.45%	$0.57	4.25%	Buy Under $65	2
WATCHLIST										
NVR, INC.	NVR	Homebuilder	NA	-	$6,226.08	0.00%	-		Buy Under $3,500	
FREEPORT-MCMORAN	FCX	Base Metals	NA	-	$41.89	1.43%	-		Waiting For Recession	
SOUTHERN COPPER CORP	SCCO	Base Metals	NA	-	$78.26	3.83%	-		Waiting For Recession	
SHERWIN-WILLIAMS	SHW	Specialty Chemicals	NA	-	$266.33	3.63%	-		Buy Under $150	
HALL OF SHAME										
ICAHN ENTERPRISES	IEP	Specialty Investments	12-09-2022	$50.39	$20.25	39.51%	$4.00	-51.88%	Sell	

Disclaimer: this hypothetical portfolio should not be considered investment advice or a recommendation to buy/sell any financial instrument. For informational purposes only. Investors should perform their own due diligence before buying or selling any financial instrument. No express or implied guarantee of accuracy or applicability to real-world trading. Risk Ratings are based on a security's fundamentals and business model rather than its current valuation.

Domino's Strikes Deal with Uber to Boost Sales Growth

On July 12, Domino's announced a partnership with the leading ride-hailing and food delivery company Uber to offer Domino's delivery orders through the Uber Eats and Postmates food delivery apps (both owned by Uber). This deal will allow Domino's to tap into more than 90 million users across both apps.

Domino's has already started offering Uber Eats and Postmates delivery options in four test markets, and plans to expand the program across the U.S. and 27 international markets by year-end.

The partnership with Uber Eats and Postmates offers a chance to jumpstart Domino's growth. As discussed in our last **Domino's update**, the company's earnings growth rebounded into positive territory in Q1 2023 after a year and a half of declines. However, on the company's quarterly earnings call in April, management cautioned that sales growth for 2023 would likely come in at the low end of its previous guidance range of 4 - 8%. Domino's has faced demand headwinds since 2022, as consumers have shifted away from food delivery back to dining out in a post-Covid world.

This new deal with Uber could jumpstart Domino's demand, as thousands of Domino's stores begin receiving orders from Uber Eats and Postmates users in the months ahead.

Until now, Domino's had resisted offering its pizza delivery service through third parties, like Uber Eats. Domino's built the number one global pizza brand by offering the fastest, most reliable pizza delivery in the industry. Allowing delivery through third party services meant losing control over the delivery experience for consumers. It also meant adding more costs by sharing delivery fees with the third party operators.

This partnership works around these problems by allowing Domino's to retain control over the delivery process. Domino's will still handle the delivery from orders placed through Uber Eats and Postmates. And the deal also allows Uber One and Postmates Unlimited users (which are the premium versions of Uber Eats and Postmates) to order Domino's with no additional delivery charge. This means no additional cost for consumers, while allowing Domino's to retain its normal delivery charge.

This deal is a win-win for Domino's. The company will retain full control over its best-in-class delivery system, without incurring any additional cost for deliveries.

To get a sense of what this could mean for Domino's growth, consider the case of Domino's top competitor, Pizza Hut. When Pizza Hut partnered with third-party delivery apps, including Uber Eats and DoorDash, its parent company Yum Brands reported a mid-single digit boost in sales from stores that accepted orders from the delivery apps.

Shares of Domino's rallied more than 10% on the news, reaching a high of $409, and currently trade at $390. That's up 30% from our recommended buy price of $300.

Domino's is a highly capital efficient business, with a dominant competitive position. This new partnership could meaningfully boost Domino's growth by tapping into millions of potential new consumers on the Uber Eats and Postmates apps.

With shares now trading above 30x earnings, and 30% above our recommended buy price of $300, we are now switching our official recommendation from buy to hold.

We recommend holding shares of Domino's (DPZ).

Mailbag

In The Big Secret on Wall Street mailbag, Porter answers letters from readers. He cannot offer individual investment advice, but can respond to general questions.

Please email us at **mailbag@porterandcompanyresearch.com** if you'd like to be featured in this segment. We'd love to hear from you!

Today's letter is from L.B., who writes:

> *L.B.: "For the recent recommendation of AAMC, you reference them beginning their operations in 2022, but some financial websites show them with financial history going back to 2012 and the financials and stock prices associated with those years are irregular. Can you comment on this?"*
>
> ***Porter: Altisource Asset Management (AAMC) was originally formed in March 2012 as an asset manager for the Front Yard Residential Corporation, a publicly traded real estate investment trust (REIT). Under this previous business model, AAMC focused on acquiring and managing a portfolio of single family rental properties within Front Yard's REIT structure.***
>
> ***AAMC closed down this previous business in the beginning of 2021, and began exploring opportunities to enter new business lines. In March of 2022, the company created the Alternative Lending Group segment that now makes up the core AAMC business, focused on originating loans to small and medium sized real estate investors for sale to institutional investors.***
>
> ***As part of this change in its business model, the company also overhauled its management team. This included hiring Jason Kopcak as Chief Operating Officer in March 2022, before promoting him to CEO in May 2022.***
>
> ***Given the closure of the previous business and installment of a new management team, we do not view the company's previous financials and share price performance as an indication of the future prospects for AAMC.***

Porter Stansberry

Porter & Co.

Stevenson, MD

P.S. If you'd like to learn more about the Porter & Co. team – all of whom are real humans, and many of whom have Twitter accounts – you can get acquainted with us **here**.

You can follow me (Porter) on Twitter here: **@porterstansb**