A tale of two IPOs

A comparison of Visa and MasterCard

BY ERIC GROVER

Visa Inc.'s initial public offering will be the final milestone in U.S. card payment networks' commercialization and emancipation from banks.

The card payment network landscape has undergone a radical transformation. A quarter-century ago all major U.S. general-purpose card payment networks except for American Express were owned by banks and not for profit. After Visa's March IPO, they will be commercial and serve banks as arms-length customers.

Visa's kindred network, **MasterCard**, had its IPO in May 2006. It has since traded up as much as 480% over the $39 IPO price. While MasterCard is a compelling and developing story, its IPO was woefully underpriced for several reasons. The market did not fully understand the payment network business and market as distinct from credit and debit cards and payment processors. Available valuation benchmarks were imperfect. The market worried too much about legal liability exposure, which was understandable given how difficult the consolidated interchange antitrust suit was to handicap, and with former FTC Commissioner Timothy Muris testifying to Congress that litigation damages trebled could approach a trillion dollars. And lastly, the story was undersold.

Visa is a terrific story, too, but it will be fairly and, even in a market roiled by credit angst and recession fears, fully valued.

MasterCard provides a superb benchmark, and the market now appreciates the unique value in a global payment network asset not previously managed as a business. It trades at 6.2 times TTM revenue.

Visa said its IPO shares will be priced between $37 and $42 per share, putting its revenue valuation multiple range at 6.2 to 7 times, a premium to its cousin.

While MasterCard and Visa are in many respects mirror images of each other, there are differences affecting each franchise's value. Differences will increase as, no longer having the same bank owners and purpose, the two global networks increasingly seek to distinguish their value propositions and served markets.

Foremost, MasterCard is a single coherent commercial global payment network. In contrast, Visa is a federation of Visa Inc. and Visa EU, which will remain a bank-owned, not-for-profit association. It has separate governance, distinct interests, and separate delivery systems. Over the long haul, this matters enormously.

In a globalization era, MasterCard will be more agile and flexible than the Visa Federation in serving global clients, particularly those with nonvanilla needs. Europe in aggregate is the world's second largest payments market. FIs such as **HSBC plc** and **RBS**, retailers **Wal-Mart Stores Inc.** and **Carrefour**, mobile-phone operators **Vodafone** and **T-Mobile**, have multinational footprints, which include European markets. MasterCard will have an easier time tailoring genuinely global propositions.

MasterCard has a two-year head start as a commercial enterprise. Its decoupled-debit-card Capital One and Lloyds TSB credit card wins testify to greater enterprise. In 2006 and 2007, after three years of losing share to Visa, MasterCard gained ground.

Visa's system architecture is more centralized, enabling additional real-time information-based value-added services to be offered. MasterCard, however, can more flexibly engage and deploy customized processing nodes with particular clients and/or national markets.

Within Visa, operating authority devolved to the regions. Joe Saunders and the new management team must invigorate the central organization.

Visa derives more of its revenue from recurring license than processing fees.

Unlike MasterCard, Visa installed new leadership. Saunders is an old bull from the U.S. credit card industry, not a payments or processing or obvious growth guy. But he is commercial and was a known quantity for U.S. issuers.

Aspects of Visa are more attractive than MasterCard.

Visa is larger. Its unit cost per dollar of purchase volume and transaction processed are therefore lower. Nevertheless, MasterCard has critical mass globally and is big enough.

Visa settled its Amex suit and with its "retroactive responsibility plan," U.S. banks will remain on the hook for liability from the consolidated interchange antitrust suit and outstanding Discover suit.

MasterCard's biggest voting shareholder is a charitable foundation it established in 2006 and which it continues to subsidize with after-tax dollars more appropriately employed enhancing payment products. Moreover, the charity insulates MasterCard management from independent shareholder pressure.

In "Subdued Vista for Visa's IPO" Michael Santoli cites Visa's and MasterCard's operating margins both being near 30% as evi-

CONTINUED >

JUDGMENT CALL

< PREVIOUS

dence Visa has "little room for profitability acceleration." To the contrary, both MasterCard and Visa can manage and grow into 50% plus operating margin businesses. Since its transformation from a bank association to a business, MasterCard has almost doubled its operating margin, rationing out measured price hikes and increasing expenses slower than transactions.

The global payment networks have enormous operating leverage. Their brand and delivery system costs are substantially fixed. If, for example, Visa were to double purchase volume and transactions processed, its revenue would close to double, while real incremental costs would be immaterial.

Both global networks enjoy tremendous pricing power, particularly with cross-border transactions, acquirers, smaller and nontraditional issuers, and specialty processing. Visa put through a medley of cross-border, processing and license fee increases in 2007. The principal area where the networks must tread gingerly on the pricing front is license and processing fees with their largest card-issuer clients. Neither will be increasing core authorization, switching, clearing and settlement domestic transaction processing fees for Chase, **Bank of America Corp.**, **Capital One Financial Corp.** or **Citigroup Inc.** any time soon.

The global payment networks have strong secular growth-in-electronic-payments tailwinds at their backs.

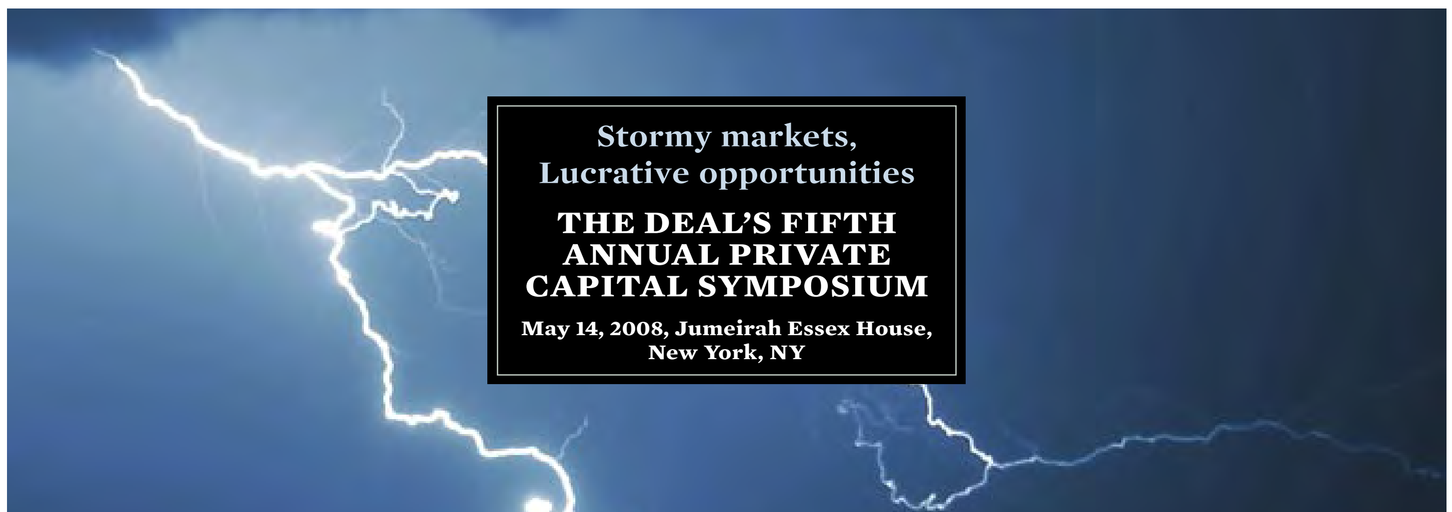
In 2007, Visa Inc.'s total payment volume increased 16%, transactions processed 12%, revenues 33%, and operating expenses excluding litigation reserves 14.3%, in line with volume but belying its intrinsic operating leverage. MasterCard's 2007 total volume increased 18.4%, transactions processed 16.2%, revenue 22.3%, and operating expenses excluding special items 10.4%.

So what should long-term investors lose sleep over?

The transcendent threat to both MasterCard's and Visa's businesses is government regulation. The payment networks have been under sustained regulatory and legal assault worldwide, and neither has found an effective strategy at containing or rolling back the menace.

Rep. John Conyers' Electronic Payment Systems Competition Restoration Act of 2008 is the latest salvo. ■

Eric Grover is a principal at Intrepid Ventures, a corporate development and strategy consultancy based in Silicon Valley.



www.TheDeal.com/pcsymposium2008 or call The Deal Events Hotline at **212.313.9291** for the latest details and to register.

The Deal Readers Save $$$! Register by March 21, 2008 and receive $400 off the standard conference rate. Use promotion code PCS08DA1.

Keynote Speakers:
Hamilton James, President and COO, The Blackstone Group
Kenneth D. Moelis, Chief Executive Officer, Moelis & Co.

Hamilton James

Kenneth Moelis

EXHIBITOR
Patterson Belknap Webb & Tyler LLP

MEDIA PARTNERS
venture magazine.com
The Daily Deal
Bankruptcy Insider
Corporate Control Alert
The Deal
EUREKAHEDGE
HedgeCo.Net
Hedge Fund Lounge
hedgefundtoo
M&A Chicago
venturecapital conferences.com

ANALYTICS PARTNER
dealogic

ASSOCIATION PARTNER
CVCA

PRESENTED BY
The Deal Events
Voice of the Deal Economy