Valuing Visa

Lessons learned from the MasterCard IPO

BY ERIC GROVER

Visa International's initial public offering will free it from bank control and governance inhibiting innovation and competition. Because **MasterCard Inc.** has paved the way, Visa will raise more capital. Absent major changes however, it is likely to command a lower valuation multiple than its cousin MasterCard.

There has been a sea change in the payments network space. A quarter of a century ago all major U.S. card payment networks except for American Express were owned by banks and not for profit. After Visa's IPO all will be commercial enterprises.

Payment networks range from commodities such as Metavante's NYCE, with a narrow undifferentiated pin-debit service and no brand power, to Visa, offering a full suite of powerfully branded credit, debit and prepay products globally.

In 2004, **First Data Corp.** acquired Concord EFS, which at the time was the largest U.S. pin-debit network, for 3 times revenue. Even considering legal liability and regulatory uncertainty, with its broader offer, potent brand, global network and scale Visa deserves a richer valuation multiple

EBay Inc. acquired PayPal in 2002 for 6.8 times revenue. With its explosive growth, strategic value accelerating e-auction transaction velocity, and potential to challenge traditional networks for payments share in electronic commerce and ultimately at the physical point-of-sale, it merited a higher multiple than Visa.

Clearly however, the best valuation benchmark starting point for Visa is its now public kindred payment network. At its current $15 billion market capitalization, MasterCard is valued at a healthy 4.7 times revenue.

For four decades the two worldwide payment networks had the same owners, customers, governance systems and missions. It is therefore not surprising that their product sets, business models, served markets, and cultures are virtually identical.

As an independent, the world's largest payment network will be driven to differentiate itself from MasterCard, to increase growth and enhance its enterprise value.

A handful of factors should decisively influence Visa's valuation relative to MasterCard.

In its favor, Visa is growing faster. From 2000 through 2005 its transactions increased 100.4% and MasterCard's only 91.5%.

Size and reach matter. Even without Europe, Visa is considerably larger than its cousin. There are more Visa cardholders, transactions and payment volume. Nevertheless, the two global payment networks' acceptance is virtually identical, and, MasterCard has network critical mass.

Visa International CEO Chris Rodrigues has left. His was largely a figurehead position, with real management authority having devolved to the regions. As a public company the role must be reinvigorated and vested with genuine CEO authority. Recentralization of executive authority will pose challenges.

Visa can establish cleaner governance than MasterCard with no shareholders beholden to management and minimal special rights for legacy bank shareholders.

Additionally, to enhance Visa's IPO relative to MasterCards' U.S. banks could indemnify it against legal liability exposure in the consolidated interchange and Amex/Discover antitrust suits.

Visa and its shareholding banks will benefit enormously from its being second out of the gate. Having MasterCard as an established public benchmark will preclude Visa stock enjoying the 185% stock price run-up MasterCard's did in the eight months after its IPO. Consequently, more capital will be raised for Visa's owners.

However, there is a huge blemish.

Visa's European Union region will not participate in the IPO. While Western Europe is the slowest growing major card payments market, it is Visa's second largest region.

European banks too would benefit from a vigorously competitive Visa. However, they have always been more comfortable with clubby, association governance and having a sleepy, pliant, reliable utility network. Moreover, an independent Visa could hurt banks insofar as it served mobile-phone operators and retailers directly.

With its separate European business Visa will be clumsier and slower than MasterCard in adopting new strategic initiatives and adapting to a changing payments landscape.

Global enterprises such as **Citigroup Inc.**, **HSBC Group** and **Royal Bank of Scotland plc**; mobile-phone operators such as **Telefónica Mobiles** and **Vodafone Group plc**; and retailers such as **Carrefour** and **Wal-Mart Stores Inc.**, have enormous

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global reach. Visa will have greater difficulty crafting nontraditional genuinely worldwide relationships.

Given different shareholders, governance, and consequently objectives and culture, alignment and coordination between Visa and the Visa EU rump will deteriorate.

Historically there was little reason for MasterCard and Visa to differentiate from each other. Now however, outside the EU, competing as for-profit public enterprises, they have an imperative to do so.

Both businesses have enormous intrinsic operating leverage. Costs are largely fixed. Variable payment transactions and volume drive revenue. Marginal costs are not material. If the two global payment networks were to persist in offering virtually identical value propositions, they would risk more price compression from giant bank customers.

If their offers and strategies remain materially indistinguishable, it will only be because of strategically lazy and complacent management.

There are areas where Visa can seek advantage.

Two-sided payment platforms such as Visa use a pricing system called interchange. Interchange typically flows from merchants through the network to issuers and in competitive markets, ultimately to cardholders. It rewards organizations serving consumers for issuing Visa products and consumers for using them. Higher interchange dwarfs transaction and licensing fees Visa's bank customers pay. Higher interchange increases network enterprise value by driving issuance and transaction growth.

MasterCard's and Visa's interchange strategies were mirror images.

Both have been singularly inept in making an affirmative case for interchange and its eminently tangible benefits to consumers.

Visa would gain from raising interchange, notwithstanding the attendant negative public relations and possible regulatory interference.

Gargantuan issuers **Bank of America NA**, **Chase** and Citi each have more than 100 million MasterCard and Visa cards.

Interchange is the second biggest component of their card businesses' profit and loss. Meaningfully higher interchange would be a powerful incentive to shift portfolio share toward Visa.

The global payment networks derive the lion's share of their revenue from transaction processing. Yet neither processes a majority of its own transactions in most national markets. Visa might more aggressively compete for, and acquire, interbank payment transaction processing of its own and of its rivals'.

MasterCard and Visa today serve the same customer set: banks. Visa could cultivate nonbank customers: retailers, mobile phone operators, insurance carriers, internet portals and governments.

The Visa brand is powerful with consumers and merchants independently of its bank customers.

While Visa product credit prices and benefits vary across banks, for consumers and merchants payment features are identical. Visa's largest bank customers would like to distinguish their Visa payment products and concomitantly diminish the network's power.

But if a BofA Visa payment product were materially different, brand and market power would be ceded from the network to large issuers. Nonetheless a more accommodating payment network could gain share. Longer term it would endanger the network's enterprise value.

Neither Visa not MasterCard has an enterprising commercial culture. One might give MasterCard an edge as the smaller, marginally more flexible network and having been public now for eight months.

While it is possible Visa will compellingly differentiate its strategy, value proposition and, therefore earnings growth prospects from MasterCard's before the IPO, it is unlikely. Absent that, Visa's hiving off its European arm means it should not rate as rich a valuation multiple as MasterCard. ■

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