

22 April 2014 | 11 pages

Data Processing & Outsourced Services
North America | United States

Global Payments, Inc. (GPN)

Analyzing GPN's Revenue Mix Shift; Transition to Better Growth and Margins Indicated; Maintain Buy and \$84 Price Target

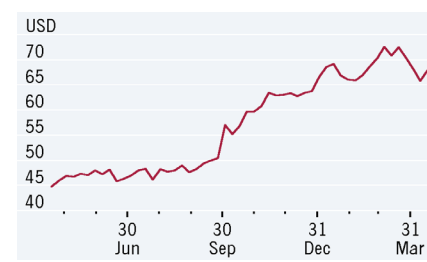
- **Key Takeaway(s)** — Under new CEO Jeff Sloan, GPN has clearly pivoted away from focusing on revenue growth at all costs and is more keenly investing in its higher margin businesses – ongoing market evolution also implies a better long-term growth potential from these changes. Recent acquisitions accelerated this shift and our analysis inside should help investors understand the underlying dynamics of GPN's various businesses and how it will help transition the company from (past) steady margin contraction to (future) margin expansion, at similar revenue growth rates, under fairly conservative assumptions. GPN remains on Citi's Focus List as our top Processor idea. The recent pullback is a Buying opportunity given these favorable dynamics and attractive valuation (~15.4x CY14 and ~13.6x CY15 P/E).
- **Focus on US Direct / Int'l** — Pro forma for the PayPros acquisition, we estimate that GPN's US Direct and Int'l businesses combine to represent ~50% of revenues and 75-80% of operating profit. These two businesses have been growing in the high single / low double digits with flat to slightly improving margins (PayPros synergies should help). As these businesses continue to grow, gain scale and as GPN deploys further M&A capital toward this type of biz, the mix effect for both revenue growth and margin expansion are meaningfully positive. We show inside that consistent growth with just stable margins is enough to drive margin expansion for the overall company, and we believe investors will reward the stock for this.
- **ISOs and Canada Less Impactful** — While the US ISO and Canadian businesses still represent the other half of revenues, they are only 20-25% of profits and shrinking in importance. Struggles here get a lot of airtime on earnings calls, but the reality is general stability in revenues / margins should be enough for GPN to hit its goals and consensus already implies lackluster performances. The ISO business has gotten a lot of attention of late, but we believe the slowing of growth here is quite favorable for margins given lower profitability and its shrinking importance may compel GPN to be more disciplined on future renewals with key ISO partners.

EPS	Q1	Q2	Q3	Q4	FY	FC Cons
2013A	0.87A	0.93A	0.87A	0.98A	3.65A	3.65A
2014E	1.00A	1.07A	0.96A	1.08E	4.11E	4.10E
Previous	1.00A	1.07A	0.96A	1.08E	4.11E	na
2015E	na	na	na	na	4.70E	4.59E
Previous	na	na	na	na	4.70E	na
2016E	na	na	na	na	5.25E	5.11E
Previous	na	na	na	na	5.25E	na

Source: Company Reports and dataCentral, Citi Research. FC Cons: First Call Consensus.

Buy	1
Price (22 Apr 14)	US\$67.79
Target price	US\$84.00
Expected share price return	23.9%
Expected dividend yield	0.1%
Expected total return	24.0%
Market Cap	US\$4,868M

Price Performance (RIC: GPN.N, BB: GPN US)



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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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GPN.N: Fiscal year end 31-May						Price: US\$67.79; TP: US\$84.00; Market Cap: US\$4,868m; Recomm: Buy					
Profit & Loss (US\$ k)	2012	2013	2014E	2015E	2016E	Valuation ratios	2012	2013	2014E	2015E	2016E
Sales revenue	2,203,847	2,375,923	2,559,024	2,790,770	2,983,507	PE (x)	19.2	18.6	16.5	14.4	12.9
Cost of sales	-784,756	-862,075	-961,884	-1,046,758	-1,118,813	PB (x)	4.5	4.5	4.2	3.8	3.3
Gross profit	1,419,091	1,513,848	1,597,140	1,744,012	1,864,694	EV/EBITDA (x)	9.2	10.1	10.3	9.4	8.6
Gross Margin (%)	64.4	63.7	62.4	62.5	62.5	FCF yield (%)	-5.3	2.7	10.9	7.3	8.2
EBITDA (Adj)	506,208	513,485	543,293	600,242	644,856	Dividend yield (%)	0.1	0.1	0.1	0.1	0.1
EBITDA Margin (Adj) (%)	23.0	21.6	21.2	21.5	21.6	Payout ratio (%)	2	2	2	2	2
Depreciation	-48,403	-55,023	-58,958	-63,748	-67,162	ROE (%)	16.0	18.6	22.3	24.0	24.7
Amortisation	-50,696	-56,765	-60,821	-67,015	-65,174	Cashflow (US\$k)	2012	2013	2014E	2015E	2016E
EBIT (Adj)	457,805	458,462	484,335	536,494	577,694	EBITDA	406,448	469,001	538,870	592,242	644,856
EBIT Margin (Adj) (%)	20.8	19.3	18.9	19.2	19.4	Working capital	-506,675	-178,275	178,126	-46,778	-43,898
Net interest	-6,902	-22,929	-26,541	-23,000	-22,150	Other	-73,248	-50,180	-92,063	-99,124	-114,733
Associates	0	0	0	0	0	Operating cashflow	-173,475	240,546	624,932	446,340	486,225
Non-op/Except	0	0	0	0	0	Capex	-109,876	-98,590	-88,270	-96,000	-104,000
Pre-tax profit	300,447	334,284	392,550	438,478	490,370	Net acq/disposals	-44,274	-434,016	-422,519	0	0
Tax	-82,881	-95,571	-111,972	-128,036	-142,698	Other	3,717	4,039	5,518	0	0
Extraord./Min.Int./Pref.div.	-29,405	-22,588	-24,134	-26,328	-28,145	Investing cashflow	-150,433	-528,567	-505,271	-96,000	-104,000
Reported net profit	188,161	216,125	256,444	284,114	319,527	Dividends paid	-6,311	-6,198	-5,769	-5,629	-5,471
Net Margin (%)	8.5	9.1	10.0	10.2	10.7	Financing cashflow	-218,186	183,522	35,667	-301,029	-293,071
Core NPAT	280,229	285,417	299,625	330,643	358,699	Net change in cash	-573,010	-100,805	141,320	49,311	89,155
Per share data	2012	2013	2014E	2015E	2016E	Free cashflow to s/holders	-283,351	141,956	536,662	350,340	382,225
Reported EPS (\$)	2.37	2.76	3.52	4.04	4.67						
Core EPS (\$)	3.53	3.65	4.11	4.70	5.25						
DPS (\$)	0.08	0.08	0.08	0.08	0.08						
CFPS (\$)	-2.18	3.07	8.58	6.34	7.11						
FCFPS (\$)	-3.56	1.81	7.37	4.98	5.59						
BVPS (\$)	14.90	15.05	16.27	17.82	20.67						
Wtd avg ord shares (k)	78,846	77,767	72,277	69,760	67,785						
Wtd avg diluted shares (k)	79,491	78,227	72,841	70,359	68,384						
Growth rates	2012	2013	2014E	2015E	2016E						
Sales revenue (%)	18.5	7.8	7.7	9.1	6.9						
EBIT (Adj) (%)	17.9	0.1	5.6	10.8	7.7						
Core NPAT (%)	13.1	1.9	5.0	10.4	8.5						
Core EPS (%)	14.7	3.5	12.7	14.2	11.6						
Balance Sheet (US\$k)	2012	2013	2014E	2015E	2016E						
Cash & cash equiv.	781,275	680,470	821,790	871,102	960,256						
Accounts receivables	183,991	190,591	214,537	256,904	299,168						
Inventory	9,864	11,057	10,736	11,684	12,429						
Net fixed & other tangibles	424,529	465,494	516,148	540,717	579,483						
Goodwill & intangibles	1,014,875	1,445,070	1,822,325	1,755,310	1,690,135						
Financial & other assets	273,609	332,374	726,763	800,951	865,217						
Total assets	2,688,143	3,125,056	4,112,300	4,236,668	4,406,688						
Accounts payable	316,313	262,890	260,129	252,981	249,883						
Short-term debt	291,811	259,796	270,000	255,000	195,000						
Long-term debt	236,565	891,134	1,250,000	1,250,000	1,250,000						
Provisions & other liab	398,111	424,629	1,047,517	1,127,947	1,206,609						
Total liabilities	1,242,800	1,838,449	2,827,646	2,885,928	2,901,493						
Shareholders' equity	1,172,184	1,146,085	1,151,053	1,217,138	1,371,595						
Minority interests	273,159	140,522	133,601	133,601	133,601						
Total equity	1,445,343	1,286,607	1,284,654	1,350,739	1,505,196						
Net debt	-252,899	470,460	698,210	633,898	484,744						
Net debt to equity (%)	-17.5	36.6	54.4	46.9	32.2						

For definitions of the items in this table, please click [here](#).

The Importance of Revenue / Profit Mix

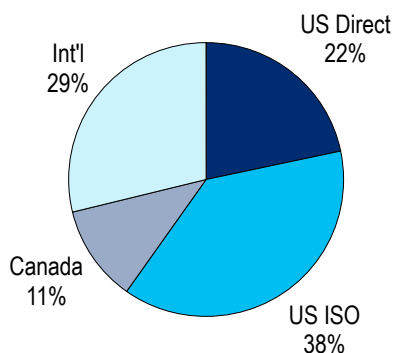
In the past, GPN's primary focus was growing the top-line of the business with a less serious focus on margins. As a result, the company's cash operating income margins declined by ~300 basis points over the past five years to reach ~19%.

While the initial steps towards a better margin profile were taken over the past 12-15 months, this greater attention to incrementally profitable growth has crystallized since Jeff Sloan was promoted to CEO (from COO). We certainly believe that not only is the transition to a more profitable company possible, it is perhaps less difficult than many in the investment community realize. In other words, it is a matter of mathematics and backbone.

However, Investors are still quite focused on the US ISO and Canadian businesses...these were admittedly an issue at different times over the past 5-7 years...we aren't saying that the business conditions in those end-markets have taken a turn for the better, but we are saying that those end-markets are less important to the overall outcome for GPN (because they represent an ever-smaller portion of profits).

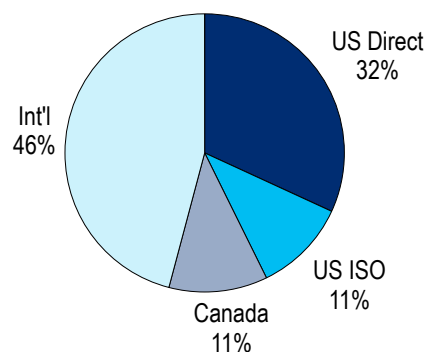
The charts below show our estimates for the current revenue and profit mix of GPN (pro forma for recent PayPros acquisition).

Figure 1. GPN Revenue Mix for FY15E (\$2.8 bil)



Source: Company Reports and Citi Research Estimates

Figure 2. Cash Profit Mix for FY15E (\$536 mil)



Source: Company Reports and Citi Research Estimates

Key Takeaways from Mix Analysis

- **Tale of Two Cities** – We estimate that GPN's revenue is split roughly evenly between the higher margin US Direct and Int'l businesses vs. the lower margin US ISOs and Canadian businesses. The former represents 75-80% of profits and are growing faster (mid-single to low-double digit growth), while the latter are only 20-25% of profits and slowing down (low/mid-single digit growth).
- **US ISOs Shrinking in Importance** – While nearly 40% of revenues even today, GPN's ISO business in the US has slowed down. Strangely, investors used to focus on the margin decline due to ISOs and now the focus has shifted to growth. We prefer to be bottom-line focused and believe the decline in importance of ISOs is, quite simply, a good thing! So, we estimate that ISO margins are in the single digits, meaning that it represents only ~11% of total profits. Therefore, as this business slows down in terms of top-line growth, the impact to margins is actually quite favorable. Its shrinking importance can also compel management to be more selective and disciplined about contract renewals (which is what we meant by our "backbone" comment earlier).

- **Canada Just Needs to Be Reasonably Steady** – Once GPN moves past the assessment related tailwinds it is experiencing in Canada now, we are modeling low single digit revenue growth with flat to slightly declining margins. With profitability roughly in-line with the corporate average, it represents only ~11% of total profits and this slow growth has a limited effect on the overall outcome.
- **US Direct Now Quite Important** – Following the recent APT and PayPros acquisitions, we believe GPN's US Direct business is now over 20% of total revenues and over 30% of total profits (margins approaching 30% by our estimate). We believe this business should continue to post strong growth (10%+) and margins should expand. As it grows, it should be accretive to margins from both mix and natural expansion.
- **Int'l Still Largest Profit Source** – GPN's Int'l business (~75% Europe / ~25% Asia) represents ~30% of revenues and ~45% of profits (margins in 30%'s). Recent growth has been double digits organically and we look for high single digit growth and stable margins from this business going forward. This above average growth should help it be accretive to the margin profile.
- **Investments in US Direct and Int'l** – Importantly, while the company was historically focused on growing the US ISO business, there has been a clear shift to focus on the US Direct and Int'l businesses. We expect further acquisitions to be in these two faster growth / higher margin businesses.

Illustrating Power of Mix

A good illustration of how mix is important is to dissect our forward assumptions based on growth / profit by business. We look at our assumed margin expansion of 10-20 bps for FY16 vs. FY15 (first apples-to-apples comparison post PayPros). As shown below, we arrive at this assumption by assuming high single digits / low double digit growth and stable margins in the US Direct and Int'l businesses, and low single digit growth and contracting margins for the US ISO and Canadian businesses. The mix effects still drive margin expansion for the full company despite the conservative assumptions of no underlying profit improvement across any individual business line.

Figure 3. The Effects of Revenue Mix on Margins for FY15-16E

Revenues	FY15E	FY16E	y/y
US ISO	\$1,064	\$1,102	3%
US Direct	\$604	\$684	13%
Canada	\$317	\$324	2%
Int'l	\$805	\$874	9%
Total	\$2,791	\$2,984	7%
Margins	FY15E	FY16E	y/y
US ISO	6.5%	6.0%	(50 bps)
US Direct	33.7%	33.6%	(7 bps)
Canada	23.0%	22.0%	(100 bps)
Int'l	36.4%	36.4%	(0 bps)
Corporate	-3.7%	-3.6%	5 bps
Total	19.2%	19.4%	14 bps

Source: Company Reports and Citi Research Estimates

Figure 4. GPN Pro Forma Income Statement FY12-16E (\$ in thou, except EPS)

PRO-FORMA ("CASH") INCOME STATEMENT (in thousands)	2012 FYE May-12	1Q13 Aug-12E	2Q13 Nov-12A	3Q13 Feb-13A	4Q13 May-13A	2013 FYE May-13	1Q14 Aug-13A	2Q14 Nov-13A	3Q14 Feb-14A	4Q14 May-14E	2014 FYE May-14	2015 FYE May-15	2016 FYE May-16
Revenues	\$ 2,203,847	\$ 590,287	\$ 588,538	\$ 578,746	\$ 618,352	\$ 2,375,923	\$ 629,685	\$ 634,122	\$ 616,452	\$ 678,765	\$ 2,559,024	\$ 2,790,770	\$ 2,983,507
YoY Growth	18.5%	8.8%	10.9%	8.5%	3.6%	7.8%	6.7%	7.7%	6.5%	9.8%	7.7%	9.1%	6.9%
Cost of Service	734,060	193,005	195,932	200,935	214,080	803,952	215,773	220,610	218,337	246,343	901,063	979,742	1,053,639
% of Revenues	33.3%	32.7%	33.3%	34.7%	34.6%	33.8%	34.3%	34.8%	35.4%	36.3%	35.2%	35.1%	35.3%
Sales, General, & Administrative	995,591	276,397	271,221	266,811	280,653	1,095,082	285,272	283,520	280,920	301,575	1,151,287	1,253,687	1,329,887
% of Revenues	45.2%	46.8%	46.1%	46.1%	45.4%	46.1%	45.3%	44.7%	45.6%	44.4%	45.0%	44.9%	44.6%
Stock Option Expense	16,391	4,222	4,956	4,885	4,364	18,427	4,788	7,177	5,304	5,070	22,339	20,847	22,287
% of Revenues	0.7%	0.7%	0.8%	0.8%	0.7%	0.8%	0.8%	1.1%	0.9%	0.7%	0.9%	0.7%	0.7%
Restructuring & Other	84,438	23,989	(14,489)	(1,189)	35,212	43,523	2,075	(3,652)	-	6,000	4,423	8,000	-
% of Revenues	3.8%	4.1%	-2.5%	-0.2%	5.7%	1.8%	0.3%	-0.6%	0.0%	0.9%	0.2%	0.3%	0.0%
Total Operating Expenses	1,746,042	473,624	472,109	472,631	499,097	1,917,461	505,833	511,307	504,561	552,988	2,074,689	2,254,276	2,405,813
% of Revenues	79.2%	80.2%	80.2%	81.7%	80.7%	80.7%	80.3%	80.6%	81.7%	81.5%	81.1%	80.8%	80.6%
Operating Income	457,805	116,663	116,429	106,115	119,255	458,462	123,852	122,815	111,891	125,777	484,335	536,494	577,694
YoY Growth	17.9%	-3.8%	7.1%	0.8%	-2.7%	0.1%	6.2%	5.5%	5.4%	5.5%	5.6%	10.8%	7.7%
Operating Margin	20.8%	19.8%	19.8%	18.3%	19.3%	19.3%	19.7%	19.4%	18.2%	18.5%	18.9%	19.2%	19.4%
Non-Operating Income (Expense)													
Interest & Other Income	9,946	1,983	2,187	2,536	3,647	10,353	3,338	3,165	2,944	3,000	12,447	12,000	12,100
Interest & Other Expense	(16,848)	(3,545)	(6,226)	(7,063)	(8,065)	(24,899)	(7,879)	(8,025)	(8,313)	(8,750)	(32,967)	(35,000)	(34,250)
Other Income (Loss)	-	-	-	-	-	-	-	-	-	-	-	-	-
Pre-tax Income	450,903	115,101	112,390	101,588	114,837	443,916	119,311	117,955	106,522	120,027	463,815	513,494	555,544
YoY Growth	18.3%	-3.8%	5.9%	-2.2%	-5.3%	-1.5%	3.7%	5.0%	4.9%	4.5%	4.5%	10.7%	8.2%
Provision for Income Tax	133,481	36,553	29,385	27,662	32,693	126,293	36,686	32,873	30,373	34,568	134,500	149,940	161,663
Tax Rate	29.6%	31.8%	26.1%	27.2%	28.5%	28.4%	30.7%	27.9%	28.5%	28.8%	29.0%	29.2%	29.1%
Minority Interest, net of tax	(37,193)	(9,752)	(9,419)	(5,993)	(7,042)	(32,206)	(8,436)	(7,197)	(6,421)	(7,636)	(29,690)	(32,910)	(35,181)
Extraordinary Item(s)	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Income	\$ 280,229	\$ 68,796	\$ 73,586	\$ 67,933	\$ 75,102	\$ 285,417	\$ 74,189	\$ 77,885	\$ 69,728	\$ 77,823	\$ 299,625	\$ 330,643	\$ 358,699
YoY Growth	13.1%	-2.8%	8.8%	4.0%	-1.8%	1.9%	7.8%	5.8%	2.6%	3.6%	5.0%	10.4%	8.5%
% of Revenues	12.7%	11.7%	12.5%	11.7%	12.1%	12.0%	11.8%	12.3%	11.3%	11.5%	11.7%	11.8%	12.0%
Pro-forma "Cash" EPS	\$ 3.53	\$ 0.87	\$ 0.93	\$ 0.87	\$ 0.98	\$ 3.65	\$ 1.00	\$ 1.07	\$ 0.96	\$ 1.08	\$ 4.11	\$ 4.70	\$ 5.25
YoY Growth	14.7%	-0.7%	8.4%	5.0%	1.5%	3.5%	14.7%	15.2%	11.0%	10.4%	12.7%	14.2%	11.6%
Basic Shares Outstanding	78,846	78,604	78,751	77,756	76,034	77,767	73,765	72,174	71,835	71,335	72,277	69,760	67,785
Diluted Shares Outstanding	79,491	79,043	79,144	78,324	76,651	78,227	74,289	72,706	72,434	71,934	72,841	70,359	68,384
EBITDA	506,208	129,333	130,253	120,477	133,422	513,485	137,833	137,273	127,097	141,090	543,293	600,242	644,856
EBITDA Margin	23.0%	21.9%	22.1%	20.8%	21.6%	21.6%	21.9%	21.6%	20.6%	20.8%	21.2%	21.5%	21.6%

Source: Company Reports and Citi Research Estimates

Global Payments, Inc.

Company description

Headquartered in Atlanta, Georgia, Global Payments (GPN) is a leading independent provider of e-Payment processing services primarily to merchants. The company serves customers located in the United States, Canada, the United Kingdom, the Asia-Pacific region, the Czech Republic, and the Russian Federation. For the fiscal year-end May 30, 2013, GPN generated ~\$2.4 billion of revenues, with 72% coming from customers located in the U.S. and Canada.

GPN's core business is providing "merchant acquiring" services that enable merchants to accept card-based payments (debit, credit, etc.) at the point-of-sale ("POS"). These services include authorization; electronic draft capture; file transfers to facilitate the funds settlement; and certain exception-based, back office support services such as chargeback and retrieval resolution. Based on Visa and MasterCard purchase volume, GPN is the sixth-largest merchant acquirer in the U.S., the third largest in the U.K., and is the second-largest acquirer in Canada.

Investment strategy

Our Buy (1) rating on GPN is partly because we consider its end-market attractive due to its large opportunity size and the underlying secular trend towards a higher number of card-based payment transactions. Further, we believe that GPN's channel strategy supports consistent above-market top-line growth and its operating model is inherently attractive in terms of cash-generation attributes. Other positive factors include the recently announced buyback. Specifically, we believe that GPN should generate ~12% cash EPS growth over the next three years. Relative to this prospective growth, we find GPN's valuation is attractive at current levels.

Valuation

Our 12-month target price for GPN of \$84 is based on P/E valuation. GPN's recent peer group average is ~18x 2014E. Within the peer group, we note that the payment processing pure plays tend to trade at a higher multiple (19x-21x). We also note that GPN's historical forward P/E multiple has tended to be in the mid-to-high teens, depending on the timeframe/duration. Given the company's underperformance in terms of growth and margin expansion, we believe a forward P/E multiple of 16x-18x (a modest discount to the peer group) is appropriate for GPN. Applying this target multiple to our CY15 cash EPS estimate of \$4.97 implies an \$84 (rounded) target price.

Risks

The key risks to our investment thesis on GPN are:

1. The global economy worsens and consumer sentiment and spending and/or small- and mid-sized business growth are negatively impacted;
2. The structurally lower-margin ISO business and ongoing pricing pressure from ISOs hurt margin more than expected, and/or expected offsets to the ISO pressure (e.g., platform consolidations, international scale benefits) are slower to materialize;
3. GPN's experiences reduced opportunities to raise prices in a post-Durbin world; and

4. Significant share price volatility around earnings.

If the impact on the company from any of these factors proves to be greater than we anticipate, it may prevent the stock from achieving our target price.

As a positive risk, if GPN were to see better-than-expected growth rates in card transaction volumes or gross dollar volumes of transactions, there could be upside to our estimates and target price. Also we believe these negative attributes are somewhat balanced by the company's consistent solid top-line growth; international market exposure (where ISOs are not a factor); and solid FCF generation.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Global Payments, Inc. (GPN)

Ratings and Target Price History Fundamental Research

Analyst: Ashwin Shirvaikar, CFA
Covered since September 8 2011



Date	Rating	Target Price	Closing Price
1 8-Sep-11	*IH	*53.00	43.92
2 8-Oct-11	Stock rating system changed		
3 8-Oct-11	*1	53.00	42.30

* Indicates change

Date	Rating	Target Price	Closing Price
4 27-Jul-12	1	*52.00	44.33
5 1-Oct-13	1	*59.00	50.70
6 19-Dec-13	1	*71.00	61.51

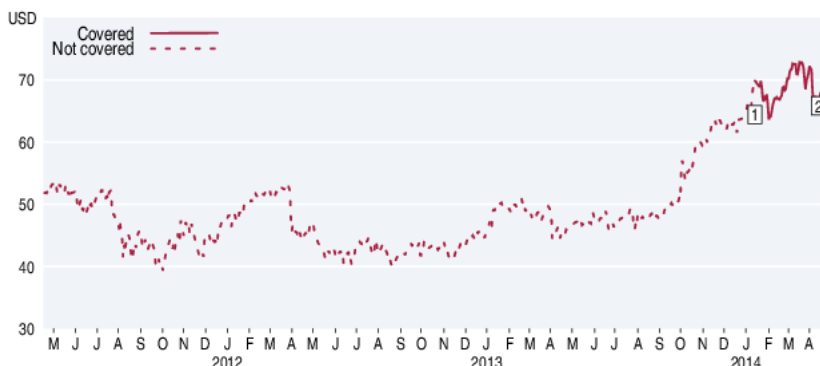
Date	Rating	Target Price	Closing Price
7 8-Jan-14	1	*78.00	64.41
8 13-Mar-14	1	*84.00	70.94

Rating/target price changes above reflect Eastern Standard Time

Global Payments, Inc. (GPN)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Ashwin Shirvaikar, CFA
Covered since September 8 2011



Date	Rating	Target Price	Closing Price
1 14-Jan-14	*ADD MP	-	69.83

* Indicates change

Date	Rating	Target Price	Closing Price
2 14-Apr-14	*REM MP	-	66.13

Rating/target price changes above reflect Eastern Standard Time

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