Q1 PayPal Analyst Call Q&A

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Opening Remarks

John Rainey

CFO, PayPal Inc

Introduction

Thank you, all of you, for joining the call this afternoon. I hope that everyone is doing well, as well as they can be under these conditions. I am joined today by Akila and Gabrielle from Investor Relations and also Erica Gessert, who is Senior Vice President, Financial Planning & Analytics in Finance. With that, we can queue up the questions.

Q&A

Bob Napoli (William Blair): John, you have talked about the operating margin expansion excluding the increase in provisions of about a 24% operating margin. You have shown some pretty good leverage over the past couple of quarters. Should we be thinking about a new level of sustainable operating margin for PayPal?

John Rainey: Bob, thanks for the question. It is probably too early to declare some of the things that we have talked about as having any permanence. Some of this is just, very clearly, a mix shift in our business. When we look at the travel and event vertical, that is ~9% of our TPV that is, for all practical purposes, going to zero, and that tends to be more card-based transactions, which tend to carry a lower transaction margin. Where we are seeing sharp accelerations in our business is on the core branded products, the funding mix of which tends to skew lower and so we are enjoying a higher transaction margin there.

On the question about sustainability of those operating margin trends, it really depends upon the sustainability of some of these behavioral shifts. I do expect some of them to continue, but it is probably too early right now to state that any of those are something that we should depend upon going forward.

What I will tell you, though, and then I will stop talking because I am rambling here, is that we believe that we have a great business model that allows us to continue to see leverage in our business. One of the things we were not asked about on the call was opportunities around the expense side and we have plenty of those, either volume or non-volume expenses, and some of these things we are learning, as we have an entire workforce that is working from home and thinking about what return to work looks like with that group of employees.

Bob Napoli: On the credit side, how should we think about future credit risk, of, say, another significant reserve build need in the second quarter and just any changes in your willingness to hold credit or your strategy working with Synchrony?

John Rainey: As it pertains to future risk, we fully reserved for the expected losses that we could foresee based upon the economic backdrop at the end of the first quarter. Obviously, if things were to deteriorate appreciably more we are going to have some impact there, but it is not as simple as just saying unemployment goes from X to Y or some other economic indicator. There are a number of different indicators that we look at and a fair amount of subjectivity. The very fact that we have provided payment holidays for much of our customers, the fact that they are receiving stimulus checks, things like that all weigh into those considerations and so we feel pretty comfortable, at this point, given the coverage that we have around that. It does not make us think differently about our credit business at all. In fact, I would say many of the things we were able to do for our customers were because of our credit platform. We have extended over a billion dollars to in excess of 30,000 small merchants around the world, to give them a lifeline through our platform that if we did not have the credit business we would not be able to do.

Thanks for the question, Bob.

Bob Napoli: Thank you.

Sanjay Sakhrani (KBW): I am glad to see you are doing well. A question on the M&A environment: I am just curious if things are better in terms of opportunities or the same, post this dislocation.

John Rainey: Sanjay, first of all, I hope you are doing well too. When this began to happen and we saw the sharp drop off in valuations in the March time period, that was one of the first things we really regrouped internally around and talked about: what is that wish list that we have, particularly at lower valuations. I think most would agree that just because someone has traded lower valuation does not necessarily make them a more willing seller. Where there are opportunities is where there are oftentimes liquidity issues or balance sheet issues and those, at times, take longer to play out in situations like this. We are canvassing the landscape to think about what makes sense in our platform that maybe was at a price point that was too rich before, but overall I would discourage anyone from thinking that we have a fundamentally different approach to M&A or capital allocation in general. However, certainly given lower valuations, it does make some deals more possible.

Sanjay Sakhrani: Okay. Just to follow up on credit and along the lines of what Bob was asking, a lot of the issuers, even the big banks that reported talked about how the macro assumptions got worse in April relative to March. I know there is a lot of subjectivity, but if we were sitting here today with the revised macro assumptions does that change the reserve coverage assumption you have made?

Then just a clarification on the OVAS: that 10 million macro-related impact, that does not reoccur if your macro assumption changes, correct? It does not change, sorry. If your macro assumption does not change, does that 10 million not reoccur?

John Rainey: It does not. The way that works is, of the $237 million charge, about $10 million of that is related to interest and so that hits the revenue line. To your point, if there were no further changes in the adjustment for reserve, that number would not change again or reoccur.

With respect to things today, I do not know that there is any information out there today that is appreciably different that would make us think differently about the charge that we have. We feel like we are leaning more on the conservative side in terms of our coverage ratio. Gabrielle, do you want to say something?

Gabrielle Rabinovitch (VP, Investor Relations, PayPal Inc): Yes. Erica, did you want to say something?

Erica Gessert (SVP, Finance and Analytics, PayPal Inc): Yes, I was just going to jump in here and give a little color. John referenced the 17% coverage ratio on the call where we are today. Obviously, unemployment rates have gone up since we closed the quarter and if you just push those rates through, that would tell us to push our coverage ratio up to a higher number, well above 20%. However, the subjectivity here is what comes in and one of the interesting things we saw with the stimulus checks coming out is an appreciable increase in payment rates within our credit book across the different vectors, both consumer and merchant. It has been an interesting dynamic here with the stimulus checks offsetting some of the unemployment rate and we are going to have to take a look at all of that activity and make a subjective call, but at 17% we feel pretty good and will continue to watch it.

Sanjay Sakhrani: Thank you.

John Rainey: Thanks, Erica. Thanks, Sanjay.

James Faucette (Morgan Stanley): Thanks for taking some time this afternoon, everybody. John, you and Dan talked and it was mentioned several times, including in questions, about the current environment and what you were seeing in terms of behavior, etc, was maybe changing or giving you some additional priorities, etc. I am just wondering not only where that may be going but how you are thinking about, as we go through the recovery process, that impacting the pace of margin expansion and profitability going forward. Is this something where there is so much incremental opportunity and things to do that it would make sense to maybe slow what you had previously been targeting or, conversely, do you think and would you anticipate that the run rate and the secular trajectory is so much faster that you can do both, increase and modify your strategies while also continuing to deliver a modest margin expansion over time? Thanks.

John Rainey: James, it is a great question and I will give you a one-off case that I think will help shed some light on how we are thinking about this.

First, I would say, generally, nothing that we are doing materially changes the way that we are thinking about the profile of our business in terms of being able to continue to have margin expansion. That is something that is almost a natural byproduct of some of the growth that we have on our platform. Offline strategy, though, is an interesting one. Many of you have asked us about this for years and perhaps we have been slower than we should have been to prioritize the offline strategy, the in store. We recognize that, right now, given that we all walk into a convenience store and there is a box of tissues next to the card reader so you do not have to touch the buttons and you can use the tissue there, or there are glass placards in between the person at the checkout and the customer, this is an opportunity for us to really go after in store in a big way right now.

As you think about the margin dynamics of that, in store is going to be probably lower margin than what we see online, I think we all recognize that, and it has the potential to be a lot more volume over time. I am not so delusional to think that we are going to have this be 50% of our TPV by the end of the year, that is not what I am saying at all. However, there is a halo benefit to a customer using PayPal in a point of sale setting or offline that while lower economics in that specific transaction, there is an increase in the ubiquity or their willingness to use us online, which we believe has a halo effect that can help our margin.

These are the kinds of things that we are wrestling with right now. If I were to come back, though, and say, two years from now, that – just to pick a number out of thin air – 25% of our TPV is now offline and that comes at a lower margin and so we have not had the same amount of margin expansion, but we have increased our TPV by some incremental percentage, or the engagement, the TPA (transactions per active), I think shareholders would recognize that there is a strong benefit to that. We do not want to just solve for margin expansion here. We are thinking about the utility of our platform in total, as we go after this.

James Faucette: Got it. In the near term, what are the key areas of activity, etc, that you are watching to see how the near term plays itself out? Obviously, you are trying to take a bit of a conservative view on the months of May and June as it relates to the second quarter, but are there particular areas or behavior and activity that you are tracking that give an indicator of how that is tracking versus what you would expect?

John Rainey: I am going to say a couple of things and then Erica can focus on some of the more granular aspects around daily average use, activation rates and things like that.

For me, I have been very focused on the macro and looking at some of the trends by vertical and by region. One hypothesis that we had early on was that when shelter in place subsided, whenever people could go back to their normal lives, whatever that was, we would see a sharper drop off in some of the verticals that we have seen strong growth in. That has not been the case, as I noted in some of the regions that have done that earlier. Now, again, it is early on, but certainly Germany is one that we have kept a close eye on and our growth rates in Germany are literally 2-3 times higher than what they were pre coronavirus. That is one thing we are looking at.

We are also looking at certain merchants, like Airbnb or even airlines, where there are longer lead times, to see the willingness of consumers to go out and do something that may involve some type of health risk because of the desire to travel or do something socially. Those are some of what we are referring to internally as 'health indicators' and Erica's team puts out a daily report that monitors all this. Erica, why do you not talk to James a little bit about some of the things that you are looking at on the analytics side?

Erica Gessert: Yes, sure. We are absolutely watching these trends day by day and, as John referenced, we have comprehensive reporting looking at it by vertical every single day and, now, state by state. As John referenced, Germany and Austria were the first that started to abate the shelter in place orders and we really have seen no meaningful change in the increase we saw versus pre COVID. State by state, we really have seen nothing yet, it is too early, but we are looking at a combination of state by state and, within the states, the verticals that pop the most are groceries, health and beauty, home and garden. We are trying to just watch those and see if there is any abatement as the orders start to lift.

The last area that also we are looking at a little bit is we have quite good demographic mapping, particularly in the US and the UK, so we are going to be watching that as well. As Dan referenced on the call, we did see a little bit of a pop in certain demographics that we were not as heavily weighted towards and we have seen a shift there as well. That will be telling as well, if we start to see those come back down, but we really have not seen any of that at this point in time.

James Faucette: That is great. Thank you, guys.

John Rainey: Thanks, James. Be well.

Craig Maurer (Autonomous Research): Thanks, John, good to hear you.

John Rainey: Hey, Craig, hope you are doing well.

Craig Maurer: Thanks. I have a couple of questions. I was wondering if you could be a bit more specific on the actual run rate of TPV growth as it exited April. Clearly, it must be significantly higher than what you reported for the month of April considering where the month probably started.

Secondly – I will just ask them both right away – what should we expect for OVAS in the quarter? There is clearly a mix of different inputs there, so how should we be thinking about that line?

John Rainey: On TPV, Craig, I do not want to be too specific there despite I appreciate the desire for that. I would rather leave it more general; that there was a trend upward as we went through the month. Some indicators: as Dan mentioned, our best day ever for transactions in total was May 1st; our highest day ever for the number of net new actives was yesterday. These trends are still accelerating and performing quite well. I do not want to, in just this call, provide anything that is more specific than that.

On OVAS, Craig, there are three or four things that are impacting that. First, you remember that we still lap the servicing transition agreement that we had with Synchrony in the second quarter and that is $55 million –

Gabrielle Rabinovitch: $58 million.

John Rainey: $58 million, to be specific. That is the first thing. We also are extending the credit holiday through the quarter and so that puts a lot of pressure on that year-over-year number. Then we have a lower interest rate environment and so that is where we recognized interest on consumer balances. Offsetting some of that is we have Honey. The net of all of that, Craig, is you are probably looking at year-over-year growth in OVAS that is sort of like the first quarter, maybe a little less. It could be negative, it is in that range.

Craig Maurer: Okay. You mentioned on the call that you were waiving certain fees. Is that going to be material to revenue in the quarter?

John Rainey: That would be included in the numbers that I just described in terms of waiving certain late payment fees and things like that.

Craig Mauer: Okay, understood. Thank you.

Erica Gessert: That reference also includes the payment holidays we are giving to credit and, from that perspective, there is some materiality, but it is included in the guide.

John Rainey: Yes.

Craig Maurer: Okay. It sounds like transaction expense has been trending lower with the mix shift change, but you are cautioning that that could return to a higher rate.

John Rainey: Yes. That will be dependent upon the mix in the business. If the mix stays where it is or was in April, then I would expect that to stay in that same range.

Craig Maurer: Okay, thanks, John.

John Rainey: All right, you bet, Craig. Take care.

Eric Wasserstrom (UBS): John, you have answered my question a little bit in your discussion a minute ago on the emphasis on omni, but can you remind us about the different assets you have there and maybe, in particular, what role Braintree plays in that expansion? My follow up is on the related margin dynamics.

John Rainey: On omni, we obviously have iZettle, which we did not talk about but, as you can imagine, being an in-store point of sale emphasis, we saw a dramatic decline in volume. Fortunately, in this case, it is not a large share for us.

Braintree does not really have much of anything in terms of omni. It is one of the things we are trying to add, though, to the Braintree capability. In fact, there are a couple of select merchants, like McDonald's, for example, where business was recently won by our competitors. One of the things that we hear that gave them that advantage was their ability to offer omni, so that is a capability that we are looking at. Really, though, Eric, when we are talking about the emphasis right now, this is more around the ability to pay with a mobile device via a QR code or some other form like that, NFC, in store and we are clearly hearing from our merchants that they demand that. Dan mentioned it, but it probably deserves more emphasis, right when COVID started in France – Erica, you will have to remind me the name of the grocery store.

Erica Gessert: Carrefour.

John Rainey: Yes, in France, came to us and said, 'We need the ability now for our customers to use PayPal and pay in store' and so we prioritized that and did it immediately. It is those types of things that you are going to hear more from until we have testing and a vaccine. Those are very real concerns that people have, but here is the thing: they are not going to go away once we have a vaccine and that is why we have dramatically re-shifted our priorities to take advantage of this moment in time. If you think about offline and whatever your own assumption is around how long that would have taken to take hold, at least in the US, just as an example. That has been accelerated dramatically, we think, and so that is why the shift in our priorities.

Eric Wasserstrom: Thanks for that. My quick follow up is – again, you touched on this a little bit, but I just want to make sure I have them all – in terms of the dynamics that influence margin a little bit, you have the mix shift in TPV, you have perhaps a bit of acceleration in the in store and then, I guess, the other dynamic is what you are doing on cost. Can you give us some sense of the magnitude of the contribution of these issues on the plus and minus side?

John Rainey: By far the largest is what is happening with the mix shift in the business and the more branded volume versus just credit card processing. That is very clearly the biggest that we have seen. It is obscured a little bit because of the year-over-year changes in our transaction margin related to the credit business and things like that, because we are not getting any transaction margin from credit right now, as you can imagine. You can do the math on what we have seen with transaction expense in terms of the benefit there, and then just keeping our other operating expenses flat year-over-year on an organic basis.

Thanks for the question, Eric.

Eric Wasserstrom: Thanks very much.

John Rainey: We have time for one last question.

Tim Willi (Wells Fargo): Thanks, I appreciate you sneaking me in here. I just want to go back to a prior question about the in store and, I guess, a clarification. You talked about, right now, as you talk about in store, using the PayPal wallet to execute a transaction as opposed to dipping a card into a terminal or handing over cash. However, you did mention the McDonald's situation. Are you saying that Braintree is thinking about whether or not to build out its platform to handle processing and POS for an in-store environment? Obviously, Stripe and Adyen have gone that way, so I am just curious if that is what you were hinting at or not, just what other thoughts you might have on that topic.

John Rainey: There are probably three or four areas where we see that we could be stronger relative to the competition and in store is one of those. Certainly, we hear that when we look at the wins and losses where we do lose business; that, at times, is a priority for a merchant that has a presence both in store and online. You are correct, that is one of the areas that we are focused on going forward.

Tim Willi: Great. That is all I had. Thanks very much for the time.

John Rainey: Okay, Tim, thanks a lot. Thanks to everyone for joining the call. We tried to jam in as much as we could there. Most importantly, I hope everyone is staying safe and we do look forward to eventually having that moment when we get to interact with you face to face again. Until then, take care. Thank you.

[END OF TRANSCRIPT]