Buy This High-Yielding Stock with an Underrated Moat

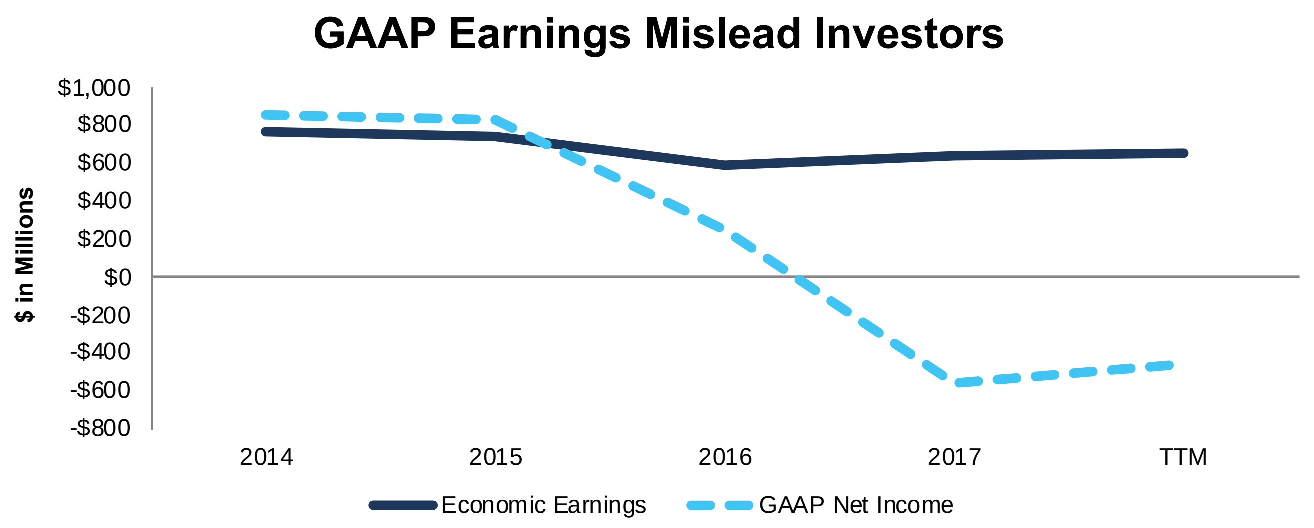
We recently published a list of "Micro-Bubble Winners" that should thrive when specific micro-bubbles burst, and while this stock didn't make the list, it very well could have. Over its 150+ year history, this company has adapted to technological transformations, built up an impressive economic moat, and become a cash cow. This strong track record, combined with a cheap valuation, makes Western Union (WU: $19/share) this week's Long Idea.

WU's Stable Profits

The narrative around Western Union is that it's an outdated relic, a company whose profitable money transfer business is being disrupted by smaller, more technologically advanced competitors. These competitors range from PayPal (PYPL), which acquired digital money transfer company Xoom in 2015, to a wide array of startups that aim to utilize blockchain technology in the money transfer business.

At first glance, reported accounting results seem to back up this narrative. Western Union's GAAP earnings declined from $852 million in 2014 to -$558 million in 2017. However, Figure 1 shows that GAAP earnings mislead investors. Western Union's economic earnings, the real cash flows of the business, declined much less: from $769 million in 2014 to $596 million in 2016. From 2016 to 2017, economic earnings rebounded, while GAAP earnings dropped, and grew by 8% to $641 million in 2017. Over the past twelve months, economic earnings have grown further to $657 million.

Figure 1: WU's GAAP Net Income and Economic Earnings Since 2014



Sources: New Constructs, LLC and company filings

The disconnect between GAAP and economic earnings has a few different drivers, some easy to spot and some more hidden. In 2016, GAAP earnings are reduced by the one-time expense of $601 million (11% of revenue) for the "Joint Settlement Agreement" that Western Union paid the FTC to settle allegations that its money transfer system was used by fraudsters.

In 2017, GAAP earnings are hit by a non-recurring $464 million write-down to its Business Solutions segment (not a part of its core money transfer business) and an $828 million one-time charge due to tax reform. Combined, these two non-operating charges accounted for 23% of revenue.

In addition to removing the unusual expenses, Western Union's economic earnings are rising faster than GAAP results due to balance sheet efficiencies. From 2014 to 2017, the company's invested capital declined from $4.4 billion to $3.1 billion, a 30% drop. This drop boosts economic earnings because it lowers the cost of capital employed by the firm.

Pricing Has Stabilized

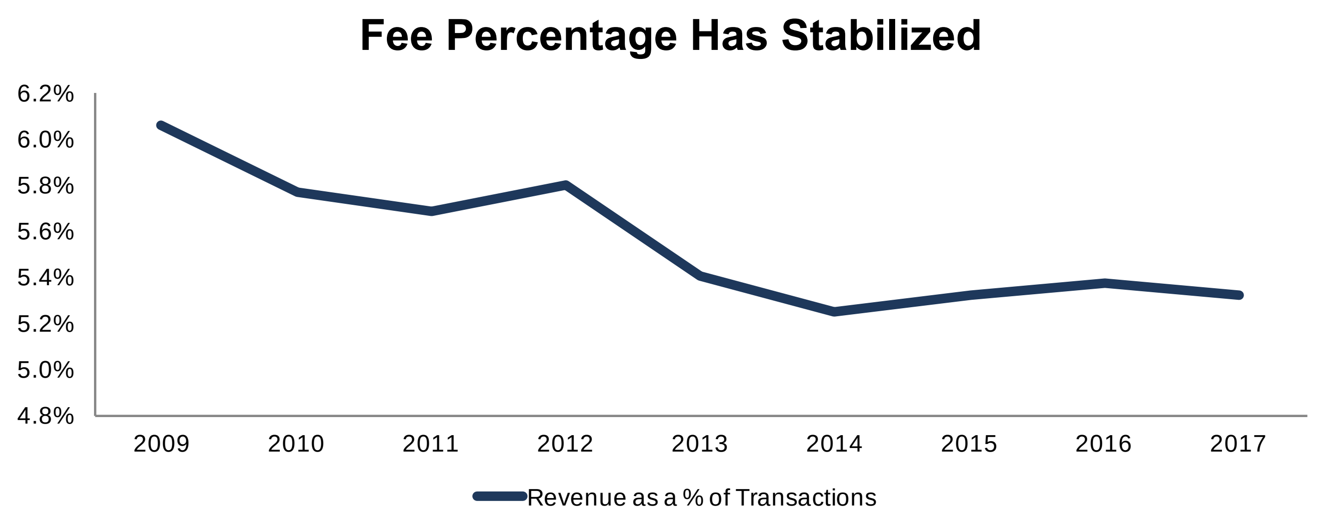
Even though its profitability has declined from its peak, Western Union still earns a top-quintile ROIC of 23%, which is well above the 7% ROIC of its most direct competitor, MoneyGram International (MGI). The company's high profitability comes largely from its pricing power, as it charges on average about 15% more than its competitors.

The bear case on Western Union assumes its pricing premium is unsustainable, but we think the company's larger agent network, greater brand awareness, ease of use, and reputation for speed and reliability provide competitive advantages that make the pricing power sustainable.

For example, Western Union's customers are likely to be resistant to switching to a new, less-trusted alternative. Over 90% of its consumer-to-consumer transactions are international, and most of these are remittances from immigrants sending money back to their families in their home country. These customers would rather pay Western Union's premium – which only amounts to ~2-3 dollars on a $300 transfer (the average transaction value in 2017) – than take the risk of the money not making it home in time.

Figure 2 shows Western Union's revenue in its consumer-to-consumer segment (which accounts for 79% of total revenue) as a percent of total transaction volume. In effect, this chart tracks fees as a percentage of transactions. Western Union's fee percentage has stabilized over the past few years after declining from 6.1% in 2009 to 5.3% in 2014.

Figure 2: Revenue as a % of Transactions Since 2009



Sources: New Constructs, LLC and company filings.

From 2009-2014, services such as Xoom put pressure on Western Union's pricing for domestic money transfer (~9% of its consumer-to-consumer business) and in major remittance corridors, most notably USA to Mexico. As a result, the company had to cut its prices to retain market share in these areas.

However, the stabilization over the past few years shows that competitors have not been able to disrupt Western Union on a global basis. In countries where the population is hard to reach or potentially unbanked, as well as areas where concerns over terrorist activity or organized crime make compliance more complicated, Western Union's network of over 500,000 agents in over 200 countries, along with its recognized brand and regulatory expertise, continue to give it durable advantage.

Regulations Provide Barrier To Entry

Regulatory expertise, in particular, is an underrated competitive advantage for Western Union. The company must comply with the regulations of any country where it does business and is responsible for the regulatory compliance of its agents, even though they aren't employees. As a result, the company has to spend significant time and resources in training agents, investigating suspicious transactions, and verifying customer identities to ensure they are not doing business with anyone on a prohibited list from the UN, EU, or US government.

Western Union spent $195 million (~4% of revenue) on compliance costs in 2017 up from ~$100 million in 2012. While this doubling of compliance costs, along with the $601 million legal settlement referenced above, hurt cash flows in the short term, they widen the company's moat in the long term. Western Union has the infrastructure in place to run these compliance programs and the margins to absorb the excess costs. New entrants into the money transfer business must spend big bucks to replicate Western Union's regulatory infrastructure.

Banks, Not Western Union, Face Disruption

While bears argue that fintech startups are coming to disrupt Western Union, the startups seem to have a different target in mind. TransferWise, a UK-based startup that now transfers over $1 billion/month, says at the top of its homepage:

"Join over 3 million people who left their banks to get a great exchange rate and a low fee."

TransferWise goes after the banks because they're lower-hanging fruit. According to a recent World Bank report, the average cost of remittances through banks is 10.4%, compared to 6.2% for money-transfer services.[1] Post-offices, another venue for money transfers, also charge higher fees at 6.8%.

It's easier for these startups to target bank customers, who are already paying excessive fees and are more directly tied into the global financial system. Western Union's customers, who may not have bank accounts or internet access[2], are much more difficult to reach.

Margin Advantage Provides an Extra Cushion

To the extent that Western Union does face additional pressure from new competitors, it has more leeway to respond to that pressure than a peer like MoneyGram. Figure 3 shows that Western Union's margin advantage over MoneyGram has increased over the past five years even though its after-tax operating profit (NOPAT) margin has declined on an absolute basis.

Figure 3: NOPAT Margin from 2013-Present: WU Vs. MGI

Net Operating Profit After Tax (NOPAT) Margin						
Company	**2013**	**2014**	**2015**	**2016**	**2017**	**TTM**
Western Union	17.8%	18.0%	18.0%	15.1%	15.1%	16.0%
MoneyGram	9.5%	8.7%	3.5%	4.5%	5.7%	4.4%
Margin Advantage: WU vs. MGI	**8.3%**	**9.3%**	**14.5%**	**10.6%**	**9.4%**	**11.6%**

Sources: New Constructs, LLC and company filings

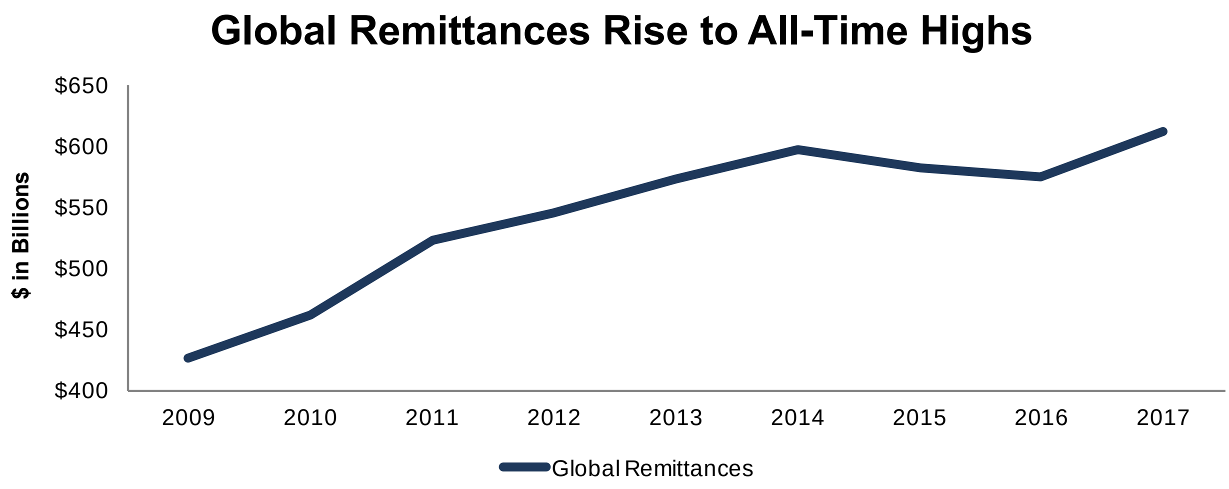
MoneyGram can't absorb pricing pressure or additional compliance costs in the same way that Western Union can. Further margin compression could drive MoneyGram out of business and allow Western Union to compensate for falling margins by expanding its market share.

Remittance Market Growing Again

As shown in Figure 2, Western Union's pricing stabilized in 2014 - 2017 even though its economic earnings continued to decline for the next two years. As Figure 4 shows, a global slump in remittance activity drove this decline, but that slump ended in 2017.

[1] The World Bank report averages costs across all remittance corridors without respect for the volume of transactions in each corridor, so the average cost here is not comparable to Figure 2.
[2] According to the World Bank, approximately 30% of all adults don't have bank accounts, while roughly 50% of the global population lacks internet access.

Figure 4: Global Remittances: 2009-2017



Sources: World Bank

Falling oil prices led to a major decline in remittances from the Middle East and Russia from 2015-2016. The stabilization of oil prices in 2017, along with accelerating economic growth in Europe and North America, drove a rebound in global remittances to $613 billion in 2017, an all-time high. The World Bank projects remittances to continue to grow by 4% in 2018.

Western Union accounted for $74.5 billion, or ~12%, of this remittance flow and is well positioned to benefit from continued growth.

Bear Case Ignores WU's Technology

Even though Western Union has clear competitive advantages today, bears argue those advantages will diminish as a greater share of the world's population comes online and is integrated into the global financial system.

This argument overlooks Western Union's success in adapting to a more digital world. Its digital money transfer service, westernunion.com, accounted for ~$435 million in revenue (10% of consumer-to-consumer revenue) in 2017 and is growing at an annual rate of 20%.

On the Q3 2017 earnings call, CEO Hikmet Ersek said that 80% of new westernunion.com customers had not used a physical location in the past 12 months, which means the service is attracting new customers rather than just cannibalizing the existing business.

Technology Will Boost, Not Disrupt, Western Union

The final bear argument against Western Union is that the company is doomed no matter what because, eventually, blockchain technology will make money transfers fully decentralized, costless, and secure. This scenario is possible, but we remain skeptical that it will manifest in the foreseeable future.

For one, blockchain technology will need to overcome the processing power and energy consumption limitations that currently make most cryptocurrencies impractical for daily consumer use. Moore's' Law suggests these problems will eventually be solved, but, for now, they are a significant hurdle for widespread adoption of the blockchain technologies.

Secondly, widespread global use of a blockchain-based money transfer platform requires the vast majority of the global population to be connected to the internet, which is still a long way off. In fact, the growth of internet penetration is slowing, as the total number of internet users only grew by 7% in 2017, down from 12% in 2016. Global internet penetration is at ~50% right now, and it's only projected to grow to ~58% by 2021. We're a long way away from having the kind of internet penetration needed to make intermediaries like Western Union obsolete.

Western Union's leadership has already taken concrete steps to keep up with changing technology. The company has a partnership with M-PESA that allows customers to send money directly into mobile "wallets" for people without bank accounts (very popular in sub-Saharan Africa), and it's testing Ripple's blockchain technology with its services. The company has even patented its own cryptocurrency for use in a secure payments network.

Western Union has navigated many technological shifts over its 160+ year history, and we believe it can continue to adapt. However, the market does not, as proven by the pessimistic expectations baked into WU's price, as we'll show below.

Consumer Trust & Regulatory Expertise Are Key Assets

Even if all the technical barriers to blockchain adoption can be solved, you still need to win the trust of consumers and the approval of regulators.

For the average consumer, the blockchain remains an interesting curiosity. Most Americans know about bitcoin, the most prominent current use of blockchain technology, but only 5% own any. For the vast majority of the public, the volatility of cryptocurrencies, their propensity to be hacked and stolen, and their limited real-world use make them too risky to trust with money meant for loved ones.

More importantly, Western Union has the advantage of regulatory legitimacy and expertise. Blockchain believers point to a future of completely anonymous transactions, but it's hard to imagine any government allowing this scenario to become a reality. An anonymous global payment network that could be used for tax evasion, money laundering, organized crime, and financing terrorist groups would be an existential threat to national sovereignty. Even if regulators can't fully shut down such a network, they could crack down enough to make it inaccessible and stigmatized for the mainstream consumer. Widespread blockchain networks will need to abide by many of the same regulations that Western Union already follows.

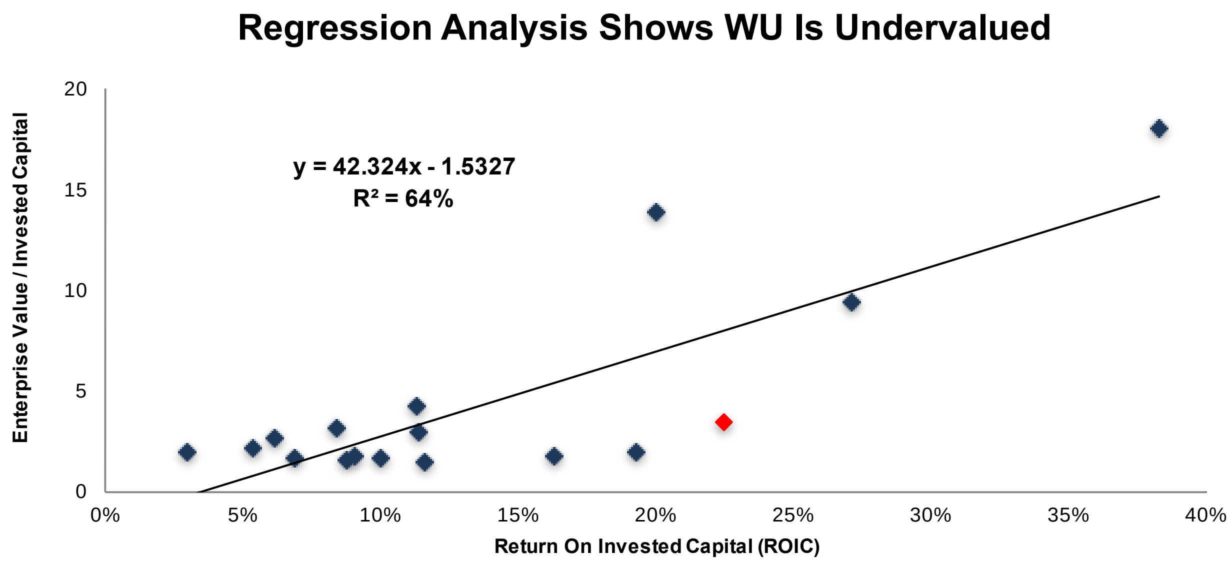
For blockchain to go mainstream, it will need the consumer trust and regulatory expertise that Western Union already possesses. A partnership (or acquisition), marrying the technology of the blockchain with the brand and consumer/regulatory relationships of Western Union, seems more likely than total disruption.

Improving ROIC Correlated with Creating Shareholder Value

Numerous case studies show that getting ROIC right is an important part of making smart investments. Ernst & Young recently published a white paper that proves the material superiority of our forensic accounting research and measure of ROIC. The technology that enables this research is featured by Harvard Business School.

Per Figure 5, ROIC explains 64% of the difference in valuation for the 17 financial services companies in Western Union's peer group listed in its proxy statement. WU's stock trades at a significant discount to peers as shown by its position below the trend line in Figure 5. WU's enterprise value per invested capital (a cleaner version of price to book) of 3.4 implies that the market expects its ROIC to decline from 23% to below 12%.

Figure 5: ROIC Explains 64% Of Valuation for WU's Peers



Sources: New Constructs, LLC and company filings

If the stock were to trade at parity with its peer group, it would be worth $52/share – an impressive 172% upside to the current stock price. Below we'll use our DCF model to quantify just how high shares could rise assuming conservative profit growth.

DCF Valuation Reveals Significant Upside

Due to accounting distortions, every data provider seems to give a different price to earnings ratio for WU. yCharts puts its P/E at an expensive 40.5, Google Finance puts it at 23.8, near the S&P 500 average, and Zacks shows it as being cheap at 10.2.

When we cut out the accounting distortions and analyze the cash flow expectations baked into the stock price, we see that Western Union is in fact quite cheap. At its current price of ~$19/share, WU as a price-to-economic book value (PEBV) of 0.7. This ratio means the market expects WU's NOPAT to immediately and permanently decline by 30%.

In reality, it's unlikely that Western Union's business will decline so precipitously immediately. When we model a more gradual and realistic decline, we see just how pessimistic the expectations are. WU's $19/share stock price implies that its NOPAT will decline by 8% compounded annually for the next 16 years, declining by 77% from its TTM level. See the math behind this dynamic DCF scenario.

Such pessimistic expectations create large upside potential. If Western Union can grow NOPAT by just 4.5% compounded annually for the next decade (benefitting from a reduction in its tax rate from ~25% to ~15%) the stock is worth ~$36/share today, an 86% upside from the current stock price. See the math behind this dynamic DCF scenario.

Catalysts: Economic Tailwinds and Potential Acquisition Target

Growth in the global remittance market and the increasing popularity of westernunion.com should provide a boost to shares over the next year.

In addition, Western Union could be a potential acquisition target for a larger company that wants to expand its money transfer services.

We already saw a recent example of a tech giant attempting to expand into the money transfer business through acquisition when Chinese company Ant Financial made an acquisition offer for MoneyGram in 2017. That deal was blocked by the Trump administration due to the concern of giving a Chinese firm the financial data of millions of U.S. citizens.

However, there are plenty of American companies that might pursue a similar deal. Facebook (FB) has been pushing into the money transfer business with its Messenger app, but that service has seen limited adoption and is only available in a handful of countries. Western Union could give it a global reach and the opportunity to serve a harder-to-reach customer base.

Other companies such as Amazon (AMZN) or Alphabet (GOOGL) could see a similar opportunity to expand their financial services offerings through an acquisition. While Ant Financial targeted MoneyGram due to its cheaper price tag and fewer regulatory concerns, Western Union should be a more appealing target to these American tech giants for whom $10 billion is a small fraction of their market cap and cash on hand.

Exec Comp Could Be Improved

Improved executive compensation practices represent another potential catalyst for Western Union. While the company earns a high ROIC, as shown above, it has destroyed shareholder value in the past through overpriced acquisitions. The $464 million write-down it took last year was the result of its $1 billion acquisition of Travelex Global Business Payments in 2011.

Western Union's compensation structure incentivizes these overpriced acquisitions by primarily rewarding executives for growth in revenue and operating income. By only focusing on the income statement and ignoring the balance sheet, the company does not encourage management to be responsible stewards of capital.

As our recent article, "CEO's That Focus on ROIC Outperform," highlighted, there is a strong correlation between improving ROIC and increasing shareholder value. Western Union should align its executives with long-term shareholders by tying a portion of their compensation to ROIC. This would be beneficial to the long-term profitability of the company, and we believe sophisticated investors would reward the company with a higher valuation in the short-term.

Dividends and Buybacks Offer Nearly 10% Yield

Western Union has increased its quarterly dividend eight times in the past ten years. Its annualized dividend has grown from $0.50/share in 2014 to $0.76/share in 2018, or 11% compounded annually. The current dividend provides a 4% dividend yield. Best of all, Western Union generates the necessary cash flow to continue paying its dividend. Over the past five years, Western Union has generated a cumulative $5.7 billion (67% of market cap) in free cash flow while paying about $1.5 billion in dividends.

In addition to dividends, Western Union has the ability to return capital to shareholders through share repurchases. The company currently has ~$700 million remaining under its current repurchase authorization, and it has bought back ~$500 million (5.9% of market cap) worth of shares in each of the past three years. When combined with the 4% dividend yield, the total yield to shareholders is almost 10%.

Minimal Insider Activity or Short Interest

Insider trading has been relatively low over the past year, with 643 thousand shares acquired and 329 thousand shares sold, for a net acquisition of 314 thousand shares, less than 1% of shares outstanding.

There are currently 36 million shares sold short, which equates to 8% of the float and 5 days to cover. Short interest has decreased 10% from the prior month and is down 12% from its 52-week high. Despite some pessimism over its future, there's not a large appetite to short the company at this cheap valuation.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

As investors focus more on fundamental research, research automation technology is needed to analyze all the critical financial details in financial filings. Below are specifics on the adjustments we make based on Robo-Analyst[3] findings in Western Union's fiscal 2017 10-K:

Income Statement: we made $1.4 billion of adjustments, with a net effect of removing $1.4 million in non-operating expense (25% of revenue). In addition to the adjustments we noted at the top of this piece, the most notable income statement adjustment was $63 million in after-tax restructuring costs. You can see all the adjustments made to WU's income statement here.

[3] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

Balance Sheet: we made $1.7 billion of adjustments to calculate invested capital with a net increase of $4 million. The most notable adjustment was $784 million in excess cash. This adjustment represented 25% of reported net assets. You can see all the adjustments made to WU's balance sheet here.

Valuation: we made $4.4 billion of adjustments with a net effect of decreasing shareholder value by $2.8 billion. Apart from the $784 million in excess cash noted above, the most notable adjustment was $3.4 billion in total debt, including $220 million in off-balance sheet debt.

Attractive Funds That Hold WU

The following funds receive our Attractive-or-better rating and allocate significantly to Western Union.

1. ALPS Series Trust: Clarkston Fund (CILGX) – 5.2% allocation and Very Attractive rating.
2. ALPS Series Trust: Clarkston Select Fund (CIDDX) – 4.7% allocation and Very Attractive rating.
3. Ariel Focused Fund (ARFFX) – 3.9% allocation and Attractive rating.
4. Hillman Fund (HCMAX) – 3.3% allocation and Attractive rating.

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Disclosure: David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, style, or theme.

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Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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