This Cash Cow Still Has Upside

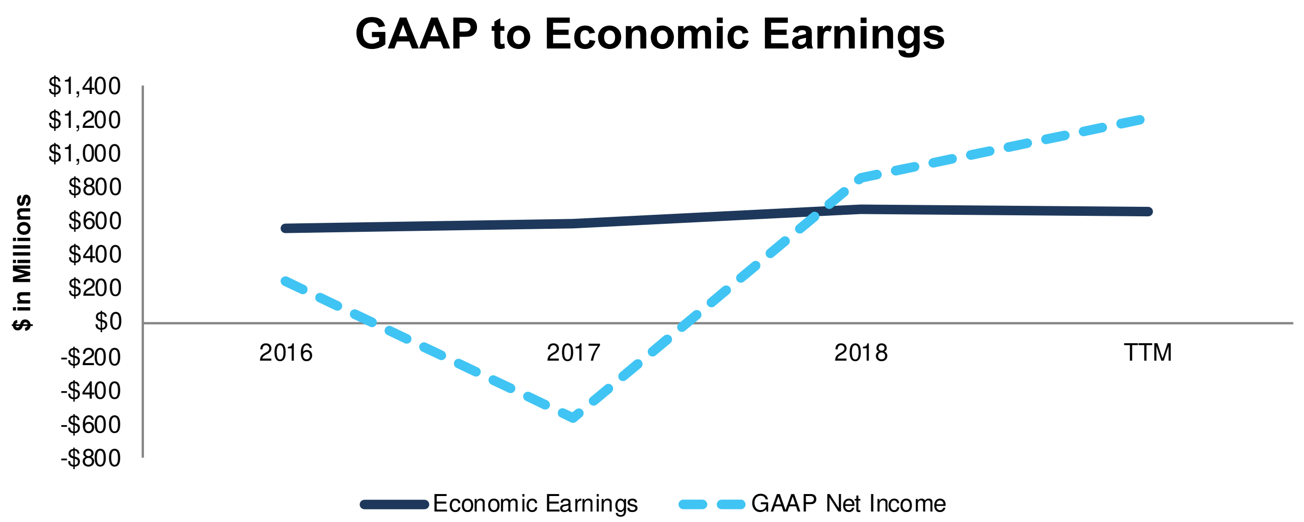
Despite fears that it is becoming obsolete, this company continues to generate lots of cash. It has successfully adapted to numerous technological changes over its 150+ years of existence, and investors are underrating its resilience.

We first made Western Union a Long Idea on September 12, 2018, and the stock is up 19% since then while the S&P 500 is flat. Even after this outperformance, the stock remains undervalued. Western Union (WU: $23/share) is this week's Long Idea.

GAAP Earnings Mislead Investors

WU's GAAP net income has been volatile over the past few years, which might lead investors to underrate the stability of this business. As Figure 1 shows, the company's economic earnings – the real cash flows of the business – have been remarkably consistent since 2016.

Figure 1: WU's GAAP Net Income and Economic Earnings: 2016-TTM



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 were 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 were 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.

Finally, TTM GAAP earnings are overstated due to a $525 million (10% of revenue) gain on the sale of its bill-pay subsidiary, Speedpay, in Q2 2019.

These non-operating items have some analysts calling WU a "turnaround" story, but economic earnings show that the business has actually been producing consistent profits the entire time.

Balance Sheet Efficiency Drives Shareholder Value

WU's stable economic earnings are even more impressive when one considers that its weighted average cost of capital (WACC) has increased from 4.5% in 2016 to 5.4% TTM.

WU has offset this rising cost of capital by significantly decreasing its average invested capital. WU's average invested capital declined from $4.4 billion in 2016 to $3.4 billion TTM.

Part of this decrease comes from the company's improved working capital efficiency. WU's net working capital has declined from -$568 million at the end of 2015 to -$1.4 billion currently. The majority of this shift comes from an increase in the company's income taxes payable, from $212 million in 2015 to $1.1 billion presently. These deferred taxes are effectively an interest free loan from the government that WU is able to use to fund its operations, which frees up more capital to return to shareholders.

WU has also reduced its invested capital through the sale of non-core businesses, such as the Speedpay sale noted above.

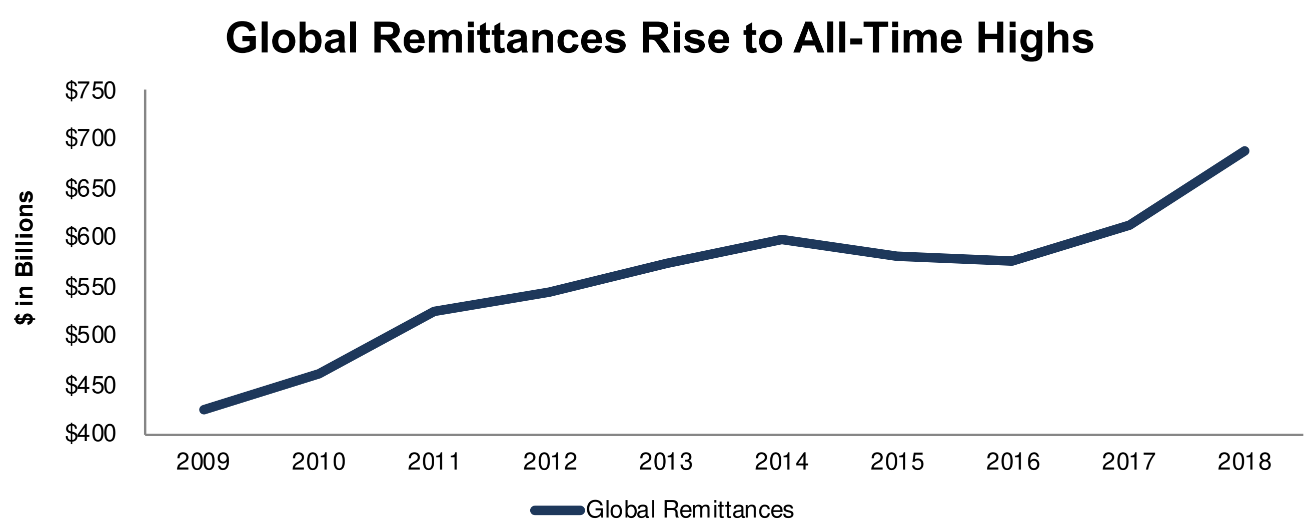
As a result of these changes, the company generated $3.4 billion (35% of market cap) in free cash flow from 2016-2018. This free cash flow allows WU to support a 3.1% dividend yield and return a significant amount of capital to shareholders through buybacks. The company's shares outstanding have fallen from 481 million at the end of 2016 to 424 million currently, a 12% decline.

Core Business Remains Strong

Selling of non-core assets to return cash to shareholders only makes sense if the core business remains strong. Fortunately, WU's core business of facilitating cross-border monetary transactions between individuals is thriving.

Consumer-to-consumer transactions accounted for 80% of WU's revenue in 2018, and over 90% of these transactions were cross-border. These cross-border payments – also known as remittances – reached an all-time high in 2018, according to data from The World Bank. Figure 2 shows the steady growth in the global remittance market over the past decade.

Figure 2: Global Remittances: 2009-2018



Sources: World Bank

Individuals transferred $689 billion worth of remittances in 2018, with Western Union accounting for $80 billion, ~12%, of those transactions.

High Barriers to Entry

The bear case against WU assumes that its share of the global remittance market is destined to decline as new technologies make cross-border transactions easier.

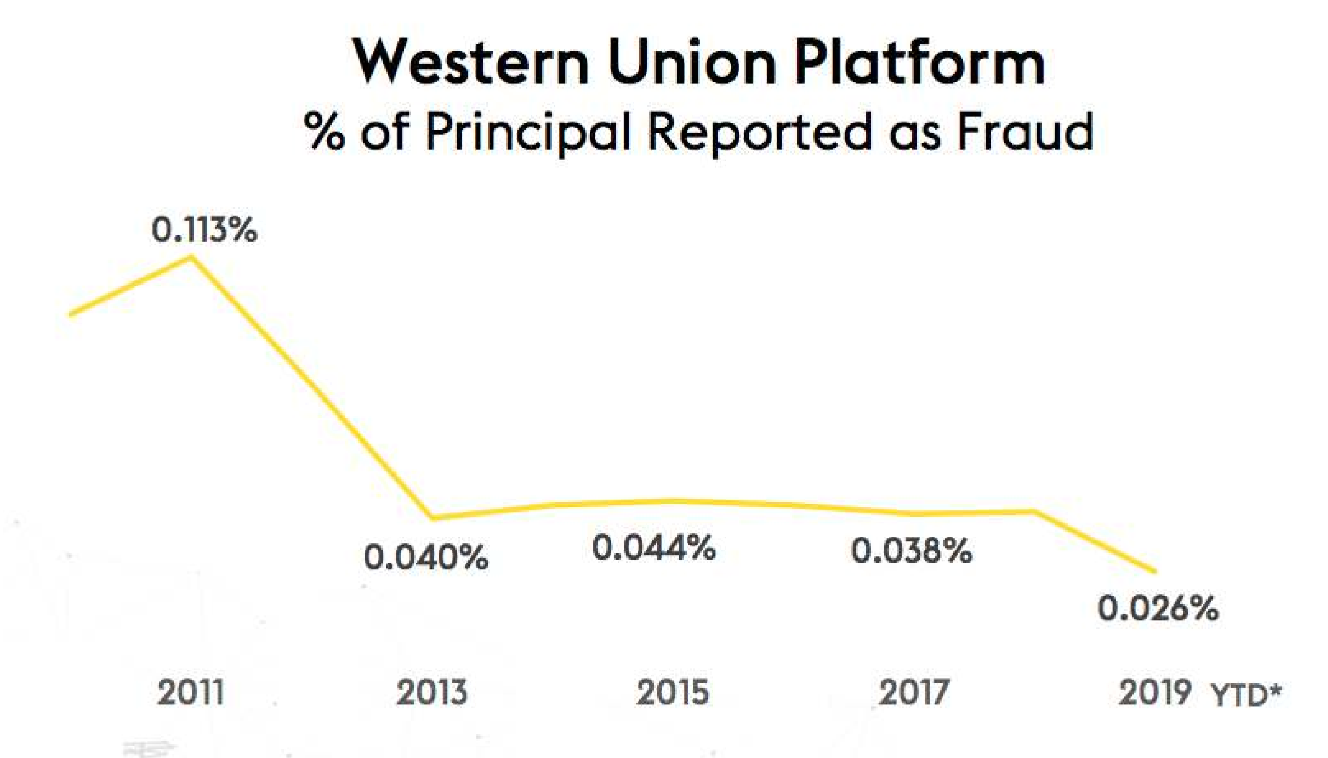
What bears miss is that the primary obstacle to cross-border transactions is not technological, but rather regulatory. WU does business in over 200 countries, which means it must comply with over 200 different regulatory regimes.

By operating in so many different regions, WU must spend significant resources to ensure payments made through its system are not being used in illegal activities, such as:

1. Fraudulent schemes
2. Money laundering
3. Financing terrorist or other criminal organizations

WU spent $200 million (4% of revenue) on compliance and regulatory costs in 2018, double the amount it spent in 2012. This extra spending on compliance has significantly reduced the amount of fraudulent transactions on WU's platform, as shown in Figure 3.

Figure 3: WU Fraud Percentage: 2011-2019



Sources: WU Investor Presentation

WU's ability to minimize fraud and comply with global regulations represents a competitive advantage that makes it difficult for new competitors to take away its market share.

Libra, the Facebook (FB)-backed cryptocurrency that was supposed to revolutionize global payments, learned this lesson the hard way. Regulators and government officials in the U.S. and Europe immediately criticized the project, and now some of Libra's major backers are considering pulling their support.

Libra is just the latest example of a technology that was supposed to make WU obsolete, and like all the others, it seems to have underestimated the magnitude of that task. The global remittance business is complicated and difficult, and WU remains one of the leaders in the industry.

Technology and Partnerships Can Drive Growth

WU has the opportunity to expand its core business through technological innovation and partnerships with larger companies.

On the technological side, WU is growing revenue from its digital platform, westernunion.com, at ~20% annually. Revenue from digital transactions now account for 13% of WU's overall consumer-to-consumer business. In addition, roughly 80% of new westernunion.com customers are new to the company, which means the digital platform is attracting new customers rather than just cannibalizing the existing business.

WU has also partnered with Amazon to launch Amazon PayCode. This service allows customers to pay for Amazon purchases in cash at Western Union locations in the US. This service allows Amazon to reach individuals who don't have bank or mobile money accounts that would let them make digital payments. The WorldBank estimates there are 1.7 billion unbanked individuals worldwide, and the FDIC estimates there are 8.4 million unbanked households in the US.

Brand Power Is Competitive Advantage

The fact that Amazon chose WU as its partner – rather than using a competitor like MoneyGram (MGI), or even developing its own system – demonstrates the leadership position WU has in its industry. WU has the most recognized brand in the industry (according to Google search data) and continues to spend heavily to maintain its wide brand awareness. WU spent $181 million on advertising last year, which is more than three times as much as MGI. Similar to its compliance spending, this advertising spend helps WU maintain a competitive advantage over its peers.

By investing in its own digital platform and leveraging its brand in partnerships with companies like Amazon, WU is able to expand its customer base and deliver a wider array of services.

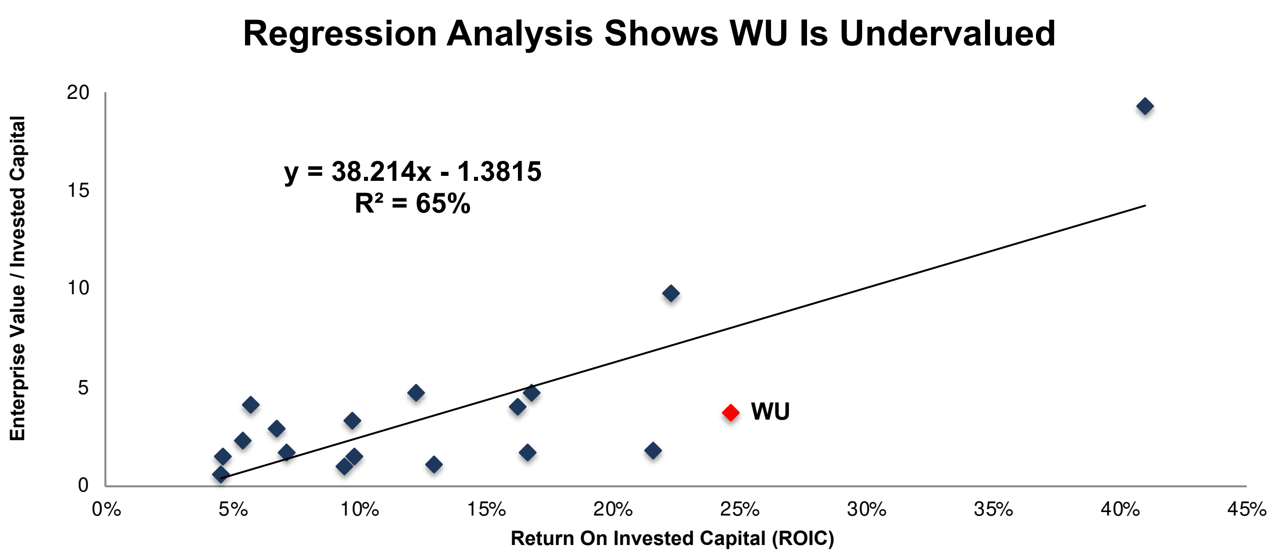
WU Remains Undervalued

Despite the 19% increase in the stock price since our original article, WU remains undervalued.

Numerous case studies show that getting ROIC right is an important part of making smart investments. This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up. The technology that enables this research is featured by Harvard Business School.

Per Figure 4, ROIC explains 65% of the difference in valuation for the 18 financial services companies that WU lists as peers in its proxy statement. WU trades at a discount to peers as shown by its position below the trend line.

Figure 4: ROIC Explains 65% of Valuation for WU Peers



Sources: New Constructs, LLC and company filings

If the stock were to trade at parity with its peers, it would be worth $56/share – 142% above the current stock price. The company's current valuation implies that its ROIC will decline from 25% to 13%.

Cheap Valuation Provides Upside

WU's cheap valuation means the stock still has significant potential upside. At its current price of $23/share, the stock has a price to economic book value (PEBV) ratio of 0.7. This ratio means the market expects the company's after-tax operating profit (NOPAT) to permanently decline by 30%. If the company just maintains current profits, the stock would be worth $31/share today, a 36% upside to the current stock price.

We use our reverse DCF model to quantify the stock's potential under different growth scenarios.

If WU can maintain its 2018 NOPAT margin of 16% and grow revenue by just 2% compounded annually for the next decade (half the rate of global remittance growth over the last decade) the stock is worth $39/share today, a 69% upside to the current stock price. See the math behind this dynamic DCF scenario.

Sustainable Competitive Advantages That Will Drive Shareholder Value Creation

Here's a summary of why we think the moat around Western Union's business will enable the company to generate higher profits than the current valuation of the stock implies. This list of competitive advantages helps WU offer better products/services at a lower price and prevents competition from taking market share.

- Unique expertise in regulatory compliance
- Widely recognized and trusted brand
- Leadership position in a growing market

What Noise Traders Miss with WU

These days, fewer investors focus on finding quality capital allocators with shareholder friendly corporate governance. Instead, due to the proliferation of noise traders, the focus tends toward technical trading tends while high-quality fundamental research is overlooked. Here's a quick summary for noise traders when analyzing WU:

- Real cash flows are steady even though reported earnings are volatile.
- The primary barriers to entry are regulatory, not technological, and are more difficult to surmount than most people realize.
- WU has growth opportunities through its digital platform and partnerships.

Catalyst: Cost Savings, Capital Return Could Send Shares Higher

In addition to its revenue growth opportunities, WU has the potential to grow its profits through cost-cutting. The company recently announced a restructuring plan that aims to save $100 million (2% of revenue) annually through closing/downsizing some of its global operating centers and flattening its organizational structure.

These cost-cutting efforts should increase the cash flows available to shareholders and allow the company to increase its already significant shareholder return.

Further, we expect more investors to appreciate the value of this overlooked and not-so-sexy company.

Dividends and Buybacks Provide 8% Yield

WU has increased its dividend in five straight years and eight out of the past ten years. Since 2014, WU has increased its dividend by 9% compounded annually. Its current annualized dividend of $0.80 equates to a dividend yield of 3.1%

In addition to dividends, WU returns capital to shareholders through share repurchases. Over the trailing twelve months, WU repurchased $501 million (5% of market cap) worth of shares. WU has $1.2 billion remaining on repurchase authorizations, and it generated $948 million in free cash flow TTM, so it can easily maintain or increase its rate of capital return going forward.

The company is currently targeting to spend $2.5-$3 billion (25-30% of market cap) on dividends and buybacks from 2020-2022.

Exec Comp Could Be Improved

Improved executive compensation practices represent another potential catalyst for WU. 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 in 2017 was the result of its $1 billion acquisition of Travelex Global Business Payments in 2011.

The company's recent history suggests it has become more disciplined about capital allocation, but its compensation structure still 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 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.

Insider Trading and Short Interest Trends are Minimal

Insider activity has been minimal over the past 12 months, with 633 thousand shares purchased and 1.4 million shares sold for a net effect of 762 thousand shares sold. These sales represent less than 1% of shares outstanding.

There are currently 59 million shares sold short, which equates to 14% of the float and 11 days to cover. The high short interest suggests the possibility for a short squeeze if WU has more good news or earnings beats.

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[1] findings in Western Union's 2018 10-K:

Income Statement: we made $297 million of adjustments, with a net effect of removing $27 million in non-operating expense (<1% of revenue). We removed $135 million in non-operating income and $162 million in non-operating expenses. You can see all the adjustments made to WU's income statement here.

Balance Sheet: we made $2 billion of adjustments to calculate invested capital with a net decrease of $293 million. You can see all the adjustments made to WU's balance sheet here.

Valuation: we made $4.6 billion of adjustments with a net effect of decreasing shareholder value by $3.5 billion million. Despite this decrease in value, WU remains undervalued. You can see all the adjustments made to WU's valuation here.

Attractive Funds That Hold WU

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

1. Clarkston Partners Fund (CFSMX) – 6.3% allocation and Very Attractive rating
2. Clarkston Fund (CILGX) – 5.1% allocation and Very Attractive rating
3. Ariel Focus Fund (ARFFX) – 3.9% allocation and Attractive rating
4. Independent Franchise Partners US Equity Fund (IFPUX) – 3.5% allocation and Very 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.

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

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

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1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).
2. **Un-conflicted** - Clients deserve unbiased research.
3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

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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