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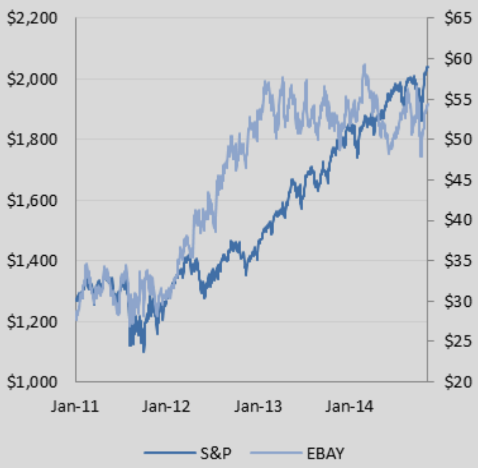
PAYPAL SPINOFF

October 29, 2014

Spinoff: PayPal
Sector: Financial

Parent: eBay Inc.
Sector: E-commerce
Target Price – $70*
Current Price – $56.6
Recommendation: Buy
Upside: +24%



SPINOFF DETAILS

Announced: September 30, 2014
Form F-10 Filing: N/A
Spinoff Ratio: N/A
When Issued Trading: N/A
Record Date: mid-2015
Distribution Date: N/A
Tax Status: Tax-Free
CEO/Chairman joins SpinCo: No
Analyst Coverage: Very high

KEY METRICS

Market Cap: 70,334m
EV: 67,539
Primary Exchange: NASDAQ
Net Debt: (2,795)
TTM Revenue: 17,548
TTM EBITDA: 4,627
TTM FCF: 4,566
52 Week Range: $46.3 – $59.7
FY Ending: December 30
Index Member: S&P 500

* SOTP plus $8 per share of cash and equiv.

Background

EBay Inc. (NASDAQ: EBAY) is a transaction-based business that successfully generates revenue from transactions and payments through eBay.com marketplace platform and the payment solution provider PayPal. The company currently benefits from its network effect derived from its global commerce division: eBay marketplace, eBay Enterprise ($9.99bn LTM revenue), and PayPal ($7.58bn LTM revenue).

The firm recently announced its plan to separate eBay into two pure-play industry leaders to bring targeted innovation and to enable optimal capital structures to match specific business units. The announcement was positively seen by the market, which immediately caused its shares to jump 7.5% upon the news. The tax-free spinoff is expected to be completed in the second half of 2015.

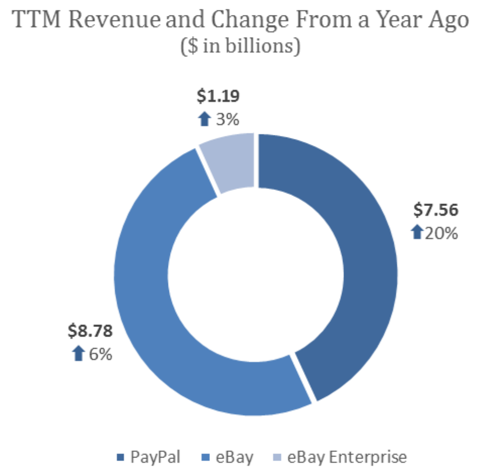
We are particularly interested in PayPal's current leader position in the digital payment space, which includes a customer base of over 157m active users, a rapid growing business and its brand awareness that has gained the firm to be named the most trusted digital wallet. The payment unit is a secure way for individuals and businesses to send and receive payments across online, mobile, and offline platforms in approximately 193 markets worldwide and in 26 currencies. This is possible thanks to its unique business model built on the existing financial infrastructure of bank accounts and credit cards backed up by a highly advanced proprietary fraud prevention system. We believe the company, as a standalone is better positioned to drive commerce innovation in payments at a global scale.

Value Proposition

As a pure player, PayPal has it all to unlock its operation's hidden value and pass it on to shareholder by capitalizing on the growing convergence between online and offline retailing – offering shareholders low risks and high probabilities of market-beating profits.

($ in millions)	ParentCo		SpinCo
Overall Description	eBay Marketplace	eBay Enterprise	PayPal
Sector	Services	Services	Financial
Business	E-commerce	E-commerce Marketing	Transaction Brokerage
Peers	AMZ, BABA, WMT	N/A	APPL, GOOGL, BABA, V, MA, "Square", "Strip", "LevelUp"
Operating Metrics			
TTM Revenue	8,784	1,187	7,577
Five-year CAGR	9%	2%	18%
% of Total	50%	7%	43%
Op. Margins	38%	7%	24%
Payment Volume	84,201[a]	4,547[b]	215,601[c]
Installed Base	152.3	N/A	156.9
Valuation			
TTM EBITDA	4,485	99	2,447
EV/EBITDA	10.0x	6.0x	16.0x
EV	44,849	549	39,158
% of Total	53%	1%	46%
Target Price	**$30***		**$32**

* Adjusted for $7,596m since management announced eBay would bear all debt post-split
[a] GMV (Gross Merchandise Volume)
[b] Net TPV (Transaction Payment Volume)
[c] GMS (Gross Merchandise Sales)



INVESTMENT THESIS

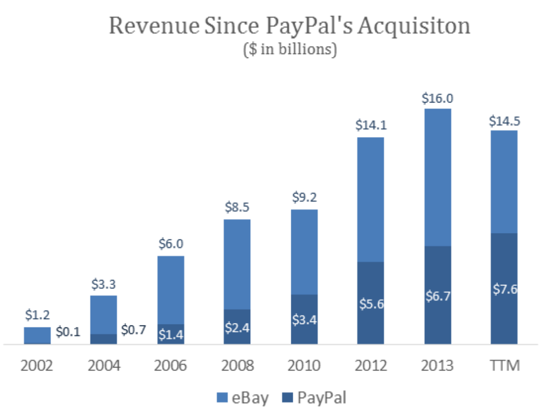
EBay will be breaking up, after activist investor Carl Icahn has been calling for the split of the company through an intense proxy fight with the firm's management; a proxy fight that ended early this April after nine intense months. After the split, investors will then be able to value PayPal separately and own it on a standalone basis. On the other hand, the firm will no longer have to contribute capital to its parent and will be able to better manage its capital deployment as well as keep investments in line with its fast growing profile that eBay's Marketplaces has long been obstructing.

We believe that management late figured out that the benefits of the interrelationship between the marketplace and the payment unit has been naturally declining over time. This problem could be optimized in an arm's length by operating agreements between the two entities. They have late figured out that PayPal was clearly the jewel and that eBay was simply covering its value as it never made sense that a global payment system could be a subsidiary of an online auction website. As a standalone, PayPal will be able to maximize its flexibility and will be able to maintain the pace required by the payment industry's changes and innovation in order to stay competitive.

PayPal is a high quality company with significant economic moats. It has low capital requirements and high brand recognition backed up by its strong market leadership. It also enjoys a strong network effect with significant switching costs. Basically, buyers like PayPal: it is secure, reliable and easy. It is secure because all transactions go through PayPal's system –as opposed to typing your credit card information into a third party site or point of sale ("POS") terminal of unreliable origin. It is easy because with a few clicks away a transaction is completed, and it offers a large measure of buyer protection. Additionally, as a middleman financial broker, PayPal makes money by charging a cost fee ranging from 1.9% to 2.9% of the purchase price –with the latter for under $3,000 and the former for receiving transfers over $100,000– plus an additional $0.30 per item bought to the merchant to receive funds.

PayPal enjoys a network effect moat. Buyers are attracted primarily by its mass merchant acceptance –both to small and big retailers– and its cross-border reach to approximately 203 markets and 26 currencies. Moreover, buyers feel attracted by its handiness of line-cutting capabilities and hand-free payments (via PayPal Here), multiple options to fund transactions with its funding mix (credit/debit card or bank account), possibility of instant credit access (via its lending arm, PayPal Credit/Bill Me Later), and P2P fund transfers (via its Braintree's app Venmo) as well as the option to store personalized coupons and loyalty points (via PayPal Beacon).

For buyers it costs nothing to send money to vendors, nor does it cost anything to set up a PayPal account. They have also the options to do payments throughout next-generation mobile leaders such as Uber and Airbnb (via Braintree). The whole platform to fund transactions is protected by security and privacy features allowing users to buy products online without giving private account information to unknown sellers. Moreover it costs nothing for buyers to send money to vendors and there are no contracts or monthly fees required. In addition, if we were willing to send you or receive money and you were not on PayPal, you would have to set up an account to get paid it or send it which only makes the network-effect wider.

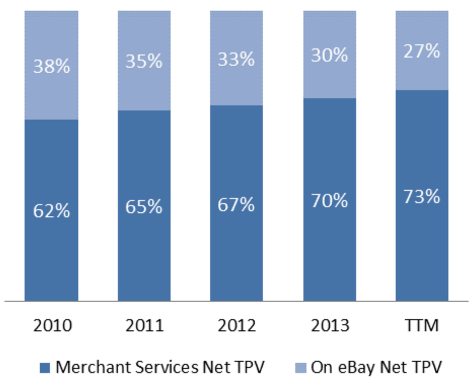


At the same time, merchants are attracted to its increasing large user base of 157 million active accounts (up 14% since last year's third quarter), small business lending products (via PayPal Working Capital), as well as its simple to integrate developing tools with its global Mobile SDK and finally its unique risk platform with one of the lowest fraud rates in the industry –less than the loss rate of 0.33% for 3Q14– supported by billions of dollars in transaction's data over ten years. Furthermore, its unique closed-loop payment system allows PayPal to have control over both ends of a transaction and identify suspicious behavior. This system has the ability to build up trust for small enterprises as well as collect massive amounts of consumer data. Also merchants do not have to sign a contract or incur any initial costs to start accepting third-party money transfer via PayPal –opposite of typical credit card issuers– which makes it even more attractive.

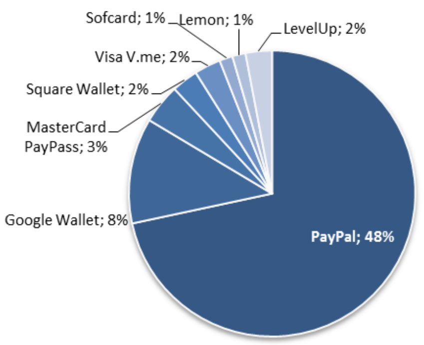
The high quality of the business was in part possible by PayPal's un-regulated monopoly position among third-party sellers on eBay Marketplace, which allowed it to charge high fees. This has led PayPal to have an impressive record of increasing its penetration on eBay's marketplace. Today they manage more than two thirds of eBay.com transactions eBay-PayPal Synergies

Source: Company presentation

% Net Transaction Payments Volume



Percent of Respondents Who Used



Source: Javelin Research

while also increasing their independence from eBay. PayPal's transaction payment volume ("TPV") of $215,601m, only about 27% of the transactions have come from eBay's Marketplace in the last twelve months. This quality is likely to remain due to the established shared services agreements between both business segments. It is in the interest of PayPal to continue their relationship at "arm's length" in order to preserve data-sharing and customer acquisition synergies. It will allow PayPal to keep having the exclusivity on eBay's e-commerce website

PayPal's network effect is well-positioned to sustain its strong momentum to keep capturing a larger share of the online, mobile, and offline payment market. Its payment system is accepted worldwide in over 1,000 stores, and it has already started partnering with many mobile startups through its Braintree subsidiary that currently processes $4bn annually in mobile transaction. Some of these include, AirBnb, Rovio, Fab, OpenTable, HotelTonight and its largest customer, Uber. It has also announced this summer it was partnering with Ryanair and the Bitcoin wallet-based firm Coinbase to start accepting the digital currency.

The firm's concept of network effect is the driver of the double digit growth rates. It allowed PayPal's TPV to grow at a whooping CAGR of 20% since 2010, which is three times as fast as the Marketplace segment growth on a gross merchandise volume-basis ("GMV") for the same period of time. Furthermore, by leveraging this concept since last year's third quarter, it has allowed more than 3.4bn of payments globally. This doubled the number of payments carried out in 2011, when the average growth rate of PayPal's active registered accounts was up 15% year-after-year.

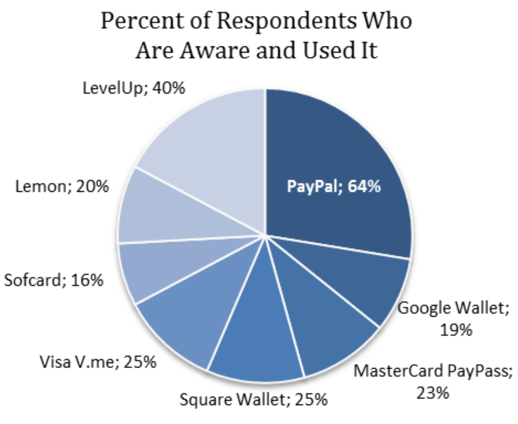
Along with its first-ever global marketing campaign that was launched this spring to encourage merchants to make cross-border sales, we believe PayPal is also well positioned for tremendous growth in the emerging markets. There is some positive signs already in some emerging countries that the shift to mobile money has started, according to study made by Quartz. This study states that there is already nine African countries were mobile-money accounts currently outnumber bank accounts. These countries include Tanzania and Kenya, which had the deepest penetration rate – 44% and 38% respectively.

Relying on a third-party contact that uses PayPal for his commerce on a regular basis, we have been told that the nature underlying payment processors services are meant to be a one-time procedure. Due to the time and effort it takes to migrate bank accounts and credit information to any other payment processor, it creates a high degree of switching cost for current active users. Furthermore, if you are a merchant you cannot transfer past customer's information transactions to any other service provider, which is essential to keep record of consumer's behavior and to better target advertising. [1]

PayPal enjoys high brand recognition. Its brand awareness is so great that a study by ComScore pointed out that two thirds (64%) of Americans, who were aware that PayPal had a digital wallet solution, also had used it. It was followed by the startup LevelUp –which only 5% of respondents knew about it, versus 75% of PayPal– with 40% awareness to usage ratio. Google Wallet, MasterCard PayPass or Visa V.me also did not have such high awareness percentage as PayPal with 41%, 13% and 8% of awareness respectively. It gives a pretty compelling sales pitch to merchants willing to accept such a specific digital wallet. All of this has placed PayPal in a strong market position that named it the most popular and trusted digital wallet in the world according to a study by Javelin Research.

As an online financial transaction broker, PayPal has limited capex needs. Its capital requirements are very low as a result of almost all of the working capital needs being allocated to fund receivables for its consumer's credit program via PayPal Credit/Bill Me Later and its merchant-lending arm PayPal Working Capital. This allows the firm to effectively approve loans based on consumer's data and business' sales history and charge an upfront fee while managing the return of the principal according to each buyer and business. As a whole, most of the firm's capex comes from computer equipment and software spending which during its last twelve months accounted for $1.83bn. With a net of $5.75bn in cash of operations that eBay and PayPal generated together, it still leaves a substantial FCF of $4.57bn (up 22% since FY 2013).

[1] *We could not try it out ourselves due to the lack of a credit card and bank account. However, we have seen PayPal accepted in few restaurants and retail stores downtown Barcelona as opposed to any other digital wallet.*



Source: Javelin Research

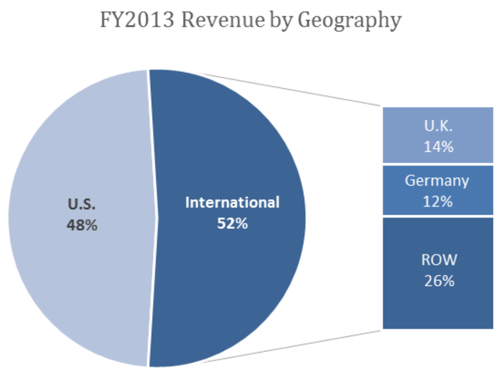
It is clear then that if PayPal is able to keep its growing momentum with its active user base, as well as incentivizing buyers and merchants to do transactions throughout their payment system. It will reap billions in transaction fees collected from the massive amount of consumer data and control, the type of targeted advertising that makes marketers drool.

INDUSTRY ANALYSIS

Threat of New Entrants

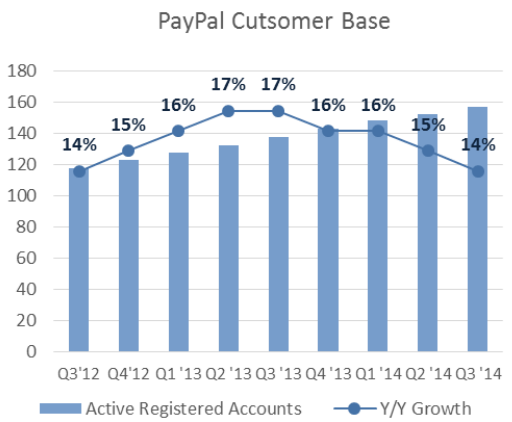
The burgeoning market covering in-store payments via handheld gadgets –set to reach $118bn in 2018, up from $3.5bn this year– is highly fragmented mainly due to new entrants coming from multiple industries. The variety of competitors go from tech and financial giants such as card payment networks (Visa and MasterCard) and issuers (Citi and JP Morgan Chase), to mobile networks operators (Softcard, a joint venture of AT&T, T-Mobile, and Verizon), mobile providers (Google and Apple), merchants (Amazon, Starbucks, MCX and Alibaba) and Silicon-based startups (Square, LevelUp and Stripe). There have also been rumors rumbling for months of a Facebook Wallet product. These competitors are creating a proliferation of digital wallets in the hope to quickly make paying via cellphone the mainstream.

More competition translates into more ubiquity for digital payments and more options for consumers, which in the end make up for the characteristics of a perfect competition. Due to the switching cost underlying digital wallets and its time-consuming set-up process as well as the current network effect PayPal enjoys, we believe that most of the emerging players are in a disadvantageous position to capture PayPal current active user base currently growing at 11% CAGR.



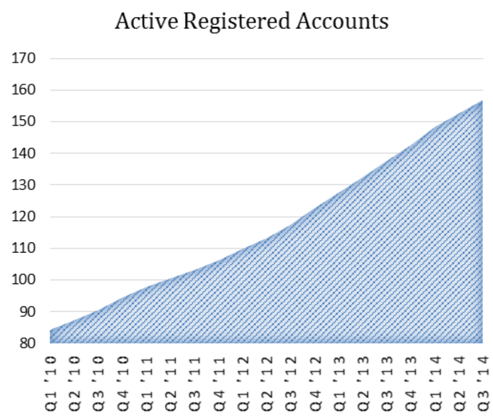
Amazon and Facebook with 230m and 1bn customers respectively, are uniquely positioned to capture market share in the mobile-social tech cycle, as all of them have a platform of consumers that are successfully transitioning from the online to the mobile world. Facebook, in the other hand, privacy being one of the biggest concerns of the social network, we see it unlikely that people end up trusting their financial data to the greatest force for publicity in the world.

Moreover, PayPal's expansion into the Chinese market has been limited by Alibaba's digital wallet launch of AliPay. With the increasing focus of PayPal into non-US markets – accounting now for more than half of current revenues – the payment unit will be better off partnering with Alibaba and its nearly 300m active user base in order to expand into emerging markets. In 2011 the Chinese giant dropped its relationship with PayPal with the fear it would ultimately ended up competing with eBay. The relationship would not have ended up prematurely if the payment system were to be a standalone company.



With the launch of the Apple Pay this September, we see Apple in between double-edged sword. On one hand, even though it is Apple Passbook that has been the most unused app to manage loyalty and gift cards, now with the introduction of Apple Pay and its new payment capabilities, it makes sense to have it. Along with the NFC-enabled and Touch ID-integrated devices that started with the iPhone 5S generation; Apple's proven ability to change consumer behavior in the mobile payment space cannot be overestimated. On the other hand, Apple is fundamentally in position to shift the payments landscape by letting more than 900,000 iOS registered users make payments at POS (i.e. Apple could use its retail stores worldwide to convert its iTunes users to use the service offline to promote this shift). Apple is clearly a threat to PayPal for in-store purchases but that does not mean PayPal has to go away. Pepsi is a threat to Coke but both can coexist. Furthermore, revenue at POS for PayPal only accounts for a merely 2% of its total TPV.

In addition, PayPal's partnership with Samsung will allow the future standalone firm to benefit from the 85% market share of smartphones that integrate Android –as reported in Strategy Analytics– and benefit from Apple's limited presence at the lower end of the smartphone market. It must be added that last year, Apple's market share in tablets dropped a whopping 60%, while Android ones grew 10% according to the states Business Insider. It would not make sense for PayPal to lock itself to an exclusive agreement on a platform like Apple with these numbers.



With the upward trend in Internet users and mobile adoption for e-commerce transactions, PayPal has still tremendous growth in this area despite the increasing competition.

Furthermore, according to a study by Ecommerce Europe, e-commerce (which is where most of PayPal's revenue comes from) accounted for €1,173.5bn of total B2C transactions in 2013, with US in the front with €315.4bn followed by China, UK, Japan and Germany – that casually match with the markets where PayPal is more present. The level at which PayPal operates within the payment industry –both online and offline– requires a strong distribution network limited by geographic factors and advanced technology such as thousands of square feet of data center space. Furthermore, new entrants would have to face PayPal's strong reputation and economies of scale to negotiating the best rates.

Threat of Substitute

When doing an online payment transaction, the only alternative is using the traditional merchant account in order for a credit/debit card to be accepted. However, there is often a monthly fee plus a transaction fee that providers such as Visa and MasterCard charge to the merchant. PayPal however, only charges a transaction fee. In addition, typical merchant services require a contract to ensure the customer will use their online credit card processing services for a certain amount of time, which PayPal does not require.

Regarding in-store payment, substitutes that would meet the same basic needs as PayPal offline payment service would be paper money as well as plastic credit/debit cards. According to some of the results from the latest study published by the Federal Reserve Board of Governors, it reported that the growth in digital-payments using mobile devices is increasing slightly from 23% of mobile-phone users in 2012 to 24% in 2013. This demonstrates that consumers are making more and more digital payments in the physical stores. A way to measure mobile payment acceptance is looking at the growth of in-store wallet payments, which according to Business Insider is expected to grow at a five-year CAGR of 154% to $189bnn in 2018. This growth will also be sustained with the number of NFC-enabled cellphones that would more than double in three years, and it is also backed up by the introduction of Apple Pay that is well positioned to change iOS user's behavior.

Even though money paper will likely not disappear in the near-term, there are positive signs coming from the increasing percentage of smartphone adoption –61% of the US population ages 18 and above own one as of December 2013– and greater in-store purchasing acceptance driven by the rapid changing payment landscape.

Finally, businesses can develop their own digital payment system and refuse to use PayPal. However, building a payment ecosystem is a much more complex process, and PayPal already offers software developers its own application programming interface ("API") to integrate it throughout PayPal Sandbox.

Bargaining Power of Customers

There is no significant customer concentration and hence it is unlikely to be an area that pressures price for PayPal. Furthermore, even though there is as much as 74 variety of payment systems available worldwide for customers, the well-established renown of PayPal's brand-named –built up since its establishment in 1998–, its funding mix as well as its large scale acceptance among retailers makes customers less price sensitive. This makes PayPal's demand be more inelastic in comparison to the other payment systems as customers are willing to pay a premium on the fees for PayPal's worldwide accepted service.

Luckily for PayPal, competitors such as Google (the second most popular payment service used according to ComScore study, 41%), Apple and Amazon as well as many others do not yet have the same comparable scale of a global payment processing solution and product offering in a wide network of retailers since the company has been forging important relationship with big retailers for years to let them accept payments directly into their network by driving down transaction costs of a typical merchant processing system.

Some of these partnerships would be its contract with Discover to extend PayPal's in-store acceptance to more than two million merchant outlets, as well as integrating PayPal's system into the next generation of Samsung smartwatches, Samsung Galaxy S5, Samsung

Tab S and Samsung Note 4. It also offers a variety of big retailers where PayPal's in-store and online system is accepted such as Walmart, Walgreens, HP, Dell, Zappos.com, Ralph Lauren, American Airlines, and many others. All of it together has led to reduce transaction cost for merchants considerably, reason why it has boosted online payment transactions via PayPal at a 24% CAGR since 2010.

Bargaining Power of Suppliers

According to the Fed study, among all smartphone owners that made an online purchase using their phones, most of them commonly used mobile payments in the form of debit cards, credit cards, bank accounts and the use of a third-party account (e.g. PayPal) with 54%, 42%, 40% and 9% respectively. With the oligopoly of financial juggernauts Visa, MasterCard and American Express as plastic card issuers and PayPal's dependence on increasing interchange fees; the supplier's bargaining power is relatively high.

However the nature of Visa, MasterCard and American Express business model makes them not have a direct connection to either side of the purchase –consumer and merchant–, they are only connected to an issuer and a merchant bank, missing the undoubted extra value created by digital transactions. Therefore, they cannot create an omnichannel for consumers to provide a better tech experience equivalent to PayPal and other third-parties. They cannot offer better targeted products/services and coupons for the user according to the consumer's past transactions. Moreover, by PayPal acting as a kind of intermediary between the customer and the credit card issuer, the firm is able to collect as much data about customer's purchasing data as the financial issuers.

Intensity of Existing Rivalry

The payment industry has shown not to be a zero-sum game, and we believe that the offline payment space with a "rule them all" digital wallet is unlikely, but an ecosystem where different players can subsist offering it's uniquely value propositions to customers will. We have seen this with Visa and MasterCard, which although they manage a larger number of active accounts globally, PayPal's TPV continues to grow at a much more rapid clip. Besides that, there is currently the threat from existing Silicon-based pure players' startups like Square, LevelUp and Stripe that are massively partnering with big players like Alibaba and Apple. It is the former and the latter startup that could become a potential risk for PayPal in the long-run.

Stripe was founded in 2009, currently valued at $1.75bn this year –up from $100m less than two years ago–, and it has already landed a partnership with Apple, Twitter and Lyfts, as well as rising funds from Sequoia Capital and ex-PayPal's CEO Peter Thiel. What makes it stand out from its rivals is the ease at which it offers a code to software programmers to quickly incorporate the payment feature into their apps and allowing businesses to start processing card payments in a variety of forms within minutes. Square, is also supported by the same venture capitalists, and it allows merchants to accept credit-card payments over smartphones and tablets with smaller fees than they had been paying via traditional credit card networks.

However, we feel that with its cash flow balances, PayPal is in place to make a purchase of these other offline payment services like Stripe and Square after it goes independent. This movement would be aligned with the same moves they did by acquiring Bill Me Later for $1.2bn –$820m in cash– in 2008 and Braintree a year ago for $800m in cash before it became a real threat. Furthermore with the amount of cash by current and potential rivals, the industry has all to converge for consolidation overtime. PayPal would be better off by keeping allocating its strong cash balances with smart acquisitions or merging with other strong player in the industry.

Moreover, according to a Fed study this year, when it comes to the digital wallets people are using to pay in stores, in 2013 it all came down to just three players: Starbucks mobile app (14%), PayPal (11%) and Softcard (1%) Google Wallet (which accounted for 7% with mobile payment off-store). This is also consistent with ComScore survey which places PayPal for momentum in that channel.

Despite consistent concerns over competition, PayPal's sales, margins and returns on capital have remained remarkably stable for the past several years, thanks to its reputation in the online payment space and ability to retain active users. The payment unit, along with its marketplace division has also been subject to an antitrust class-action lawsuit for being the only viable option on eBay.com, which shows its unique competitive strength.

VARIANT PERCEPTION

EBay shares have rallied up over 130% since the financial crisis in 2008 to only get stuck for over two years in between the range of $50-$60 due to the bitter and the sweet it has had during this period. The obscured underlying values of its different business units have brought eBay, as a whole, to trade at a conglomerate discount when comparing it to its e-commerce and financial services peers at a current 14.6x EV/EBITDA. It has been mainly driven by the many investors focused on discounting the short-term problems of the marketplace platform, as well as the extrapolating increasing pressure by new entrants on both the marketplace and payment units. These current events have brought PayPal to be misunderstood by many, which has created an interesting entry point for value investors.

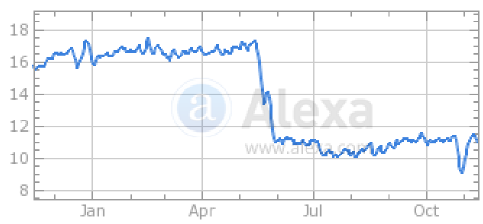
These short-term events can be easily mitigated considering a long-term time horizon and hence should be considered an opportunity rather than a headwind.

PayPal is a high-growth hidden gem obscured by its parent. Its worldwide-known brand and strong network effect has allowed the firm to have high margins and high FCF along with enough room to improve efficiencies in a double digit growth industry. The payment unit has grown sales at a CAGR of 18% since 2010 driven mainly by the more increasing interdependence trend on TPV from merchant services – 73% from total net TPV vs 27% of TPV from eBay's site. This has led PayPal to earn almost as much revenue as eBay's marketplace business and grow at a pace that is three times faster. It is clear that the decline in the two company's crossover business has been noticeable in the past year alone.

The market is currently valuing PayPal indirectly at eBay's multiple of approximately 14.6x EV/EBITDA. This figure is well below of what a firm with growing sales at a double digit rate for over four years, with strong sustainable moats, with room for improving its already high margins and with strong potential to help redefine the future of its industry, would trade at.

The e-commerce and payment space is crowded with strong new entrants. The competition environment in the payment space increased with Alibaba's launch of AliPay and current financial incumbents like Visa and MasterCard as well as the recent release of Apple Pay. This new environment has discouraged many investor's enthusiasm on the stock. However, the market is missing the fact that, for example, Apple Pay is focused in payments at retail POS –an offline mobile payment solution – which represents a very small percentage of PayPal's overall revenue, which accounts for only $4bn in mobile transactions annually through its Braintree subsidiary.

eBay.com % of Visitors Sourced from SEO



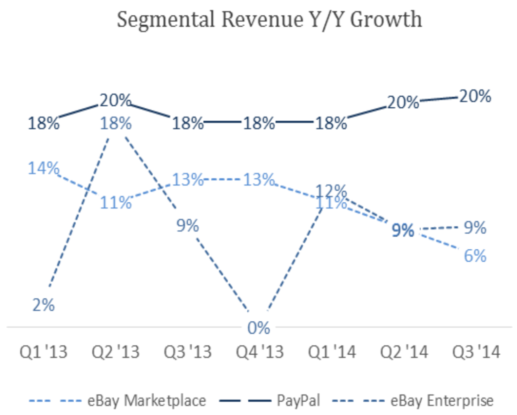
Source: Alexa.com

With PayPal representing almost half of eBay's revenues with its steeping growth rate it is clear that anything that threatens the payment unit's future growth will very likely have a negative impact on eBay's overall growth.

Finally there has been some short-term events that have prevented the stock to keep its momentum and have spooked away some investors. Some examples from this year are:

- Its declined SEO visibility in Google's new Panda 4.0 algorithm that made eBay.com website lose 33% of traffic
- the security concerns on user's passwords after a cyber-attack that affected its database and made eBay ask their users to change their passwords,
- high employee turnover with PayPal's president David Marcus leaving eBay to run Facebook's messaging unit early this February,
- management recently reduced FY 2014 revenue guidance due to marketplace's segment continued to face headwinds, and;
- recently disappointing profitability ratios with negative and below-average ROIC and ROE for current year

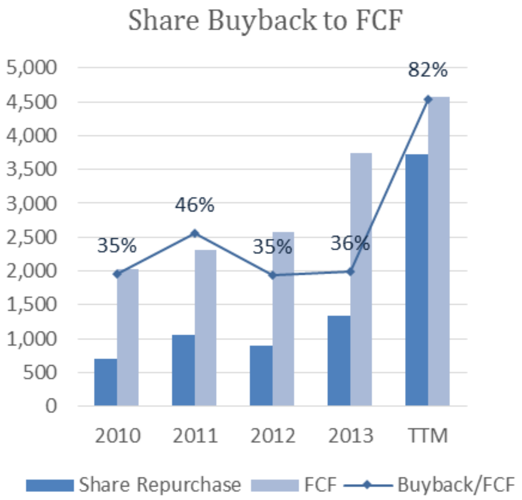
TARGET PRICE



There is plenty of room for PayPal to unlock its hidden value as it spins off eBay by putting the firm in a better competitive position and by allowing it to focus more on strategy towards the rapidly changing competitive environment. The spinoff will also allow the two different types of investors to better value both firms, which at the same time reduces bureaucratic hurdles and allows both management teams to take independent decisions quickly.

The payment unit is by far eBay's most important cash cow, bringing in about 45% of its overall revenue for 3Q14. Its high margins from its increasing TPV –CAGR of 20% versus eBay's GMV CAGR of 7% since 201– could be used to sustain the double digit organic growth, as well as pursuing attractive investments like M&A opportunities –as it did with Braintree for $713m in December 2013– aligned with the further consolidation of the industry.

The firm will have solid financials as a stand-alone firm with an approximated $2.45bn in EBITDA that it generated in the last twelve months, its operating margins sustained at the 24% levels and finally with EBIT growing from $722m in 2010 to $1.83bn on a TTM-basis. There is also room for operating improvement as efficiencies post-spin realize that could propel PayPal's margins to the 28-30% range that it used to have back in 2002 (before it got acquired by its today's parent, eBay). A signal to that is its scaling potential with PayPal's transaction expense declining to 0.95% as of 3Q14 –1.10% in FY2010– which along with its high-volume of users, the company can charge a more reduced take rate and still keep growing TPV at double digit growth by making their reduced costs more attractive to potential customers. Furthermore the business unit will have the proceeds it would generate from its IPO in the second half 2015, and it will be left with no debt as eBay will assume the $7.5bn post-spin; giving PayPal a more attractive profile to raise funds from the capital markets.



Alternatively, in the mid-term, eBay has given proof to know the usage of its growing FCF stream (6.7% FCF/EV yield for the past twelve months) and return capital to shareholders throughout share repurchases ($7.75bn spent buying back shares since 2010). With FCF accounting today for 26% of sales since last year's 3Q, up three percentage points from 2013's FY results; this trend is likely to continue. Furthermore, EBay shored up over $9bn of offshore cash in the second quarter and after paying 30% of it in taxes, their cash per share jumped 43% to $8.4 the next quarter.

This infusion of cash could sustain its authorized buyback program with $2.2bn left to repurchase shares without altering past cash levels. At the Q3's month-end stock price of $56.63 eBay could buy over 39m shares shrinking down 3.24% of current outstanding shares.

Embedded in our current assumptions of $70 per share (20% discount to market) are stand-alone valuations of $32 per share for PayPal, $30 per share for eBay's Marketplace/Enterprise, and $8 per share in cash. Regarding a lack of peers comparison for PayPal we have estimated a multiple of 16x EV/EBITDA. This figure would come from two times the EV/EBITDA multiple of 6.7x of PayPal in 2002 plus an adjustment that leaves room for future growth. This adjustment assumes that PayPal's net TPV growing 24%, sustained by 30% growth from merchant services and 10% growth on eBay transaction. This TPV growth rate is based on the double digit payment volume growth as well as an increase in number of merchants –driven by large partnerships– that are likely to bring lower take rates.

PayPal in 2002

Market Cap	1,390
+ Cash	1,119
- Debt	-17
EV	**2,492**
Gross Profit	1,000
- Op Expense	-646
+ D&A	16
EBITDA	**370**
EV/EBITDA	**6.7**

Source: SEC filings

When coming up for the SOTP multiple it will be more accurate to get the median for those pure play competing in the same market as PayPal. Unfortunately, those similar to PayPal such as Square, Strip and Softcard still do not trade publicly. Moreover we believe it would be wrong to value PayPal based on the EBITDA of the most common money processors like Visa and MasterCard. As explained earlier, PayPal always pays an interchange fees to these two, and it makes up for a big expense that PayPal has to bear. This leads to operating margins divergences for both types of companies of 60% versus 20% for Visa and MasterCard, and PayPal respectively. This is the reason why PayPal balance to balance transfers transaction is much cheaper for them, since it does not have to pay anyone to process the payment.

At an estimated 16x EV/EBITDA the stock could always be cheaper. However, with current multiple strength and the likely chances of the stock to mirror the typical pattern of spinoffs and price declines after months of being spun-off –with selling pressure coming from eBay's Marketplace focused investor– PayPal provides a significant margin of safety. This, along with the current company's strength, it fairly outweighs the recent somewhat disappointing recent returns to shareholders.

RISK PRICE

It is very hard to see how you could lose money owning PayPal with an increasing operating margin expansion from 21% in 2010 to 24% in TTM as a subsidiary of a non-business related parent, no debt left in its balance sheet at the time of the split-up and proven cash generation.

The biggest threat to PayPal is that its margins could be harmed by banks and other payment processors that accept transactions from payment card networks –such as Visa and MasterCard– throughout its funding mix. The latter group charge the so-called "interchange fees" to enable PayPal's acceptance of credit cards and debit cards – as well as some other types of prepaid cards. These interchange fees make up for the biggest direct cost of revenues when processing online payments with over 40% of PayPal's TTM revenues designated to fund these expenses.

Top 10 Spinoff Since 2005

Rank	Parent	Spinoff	Market Cap	Year
1	Altria Group	Philip Morris	$106.6	2008
2	Abbott Labs	AbbVie	$55.5	2013
3	Altria Group	Kraft Foods	$46.2	2007
4	**eBay**	**PayPal**	**$39.2 (est)**	**2015**
5	CBS Corp	Viacom	$32.2	2006
6	Hewlett-Paclard	HP	$32 (est)	2015
7	Mondelez Int	Kraft Foods Group	$26.9	2012
8	Timer Warner	Time Warner Cable	$22.5	2009
9	Tyco Int.	Covidien	$21.5	2007
10	Duke Energy	Spectra Energy	$20.8	2007

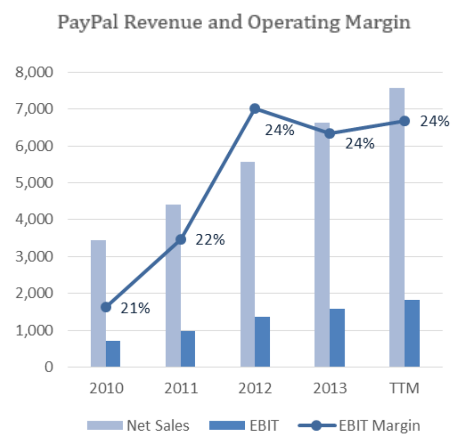
Source: Dealogic (HP estimate)

This interest expense varies over issuer's card type, amount of transaction; region, etc. however, in the US the interchange fee averages 1.79% –one of the highest in the world– and US transactions accounts for 48% of PayPal's worldwide payments. That is the reason why PayPal encourages customers to add bank accounts to their system or use its PayPal balances, to not only improve its margins but also to be able to charge lower take rates and attract more price-sensitive users.

In our current bear-case assumption of $59 per share are stand-alone valuations of $29 per share for PayPal and $21 per share for eBay's Marketplace/Enterprise. It assumes a future where transactions expenses increase –due to interchange fees and assessment– triggering a drop in PayPal's operating margins due to higher take rates. However, even in this worst-case situation with an estimated market cap of $39bn –unadjusted for cash– PayPal would rank fourth on a list of the largest spinoff by market cap of spun-off entities since 2005.

CATALYST

As a recently spun off entity PayPal's independent stock will likely take the pattern of many spinoffs. Investors will come to understand the company better, as the company realizes typical post-split efficiencies and the market comes to appreciate its cash flow and unique capacities. Citing a commonly-known study by Patrick Cusatis, et al. published in 1993 stated that spinoff companies surpassed the S&P 500 index by an average of 30% during the first three years of trading post-split.



With its accelerating earnings growth and double-digit revenue the stock could jump into the "growth stock" radar luring capital from big growth oriented funds. Unfortunately a potential selling pressure from index funds is not likely, since we value the company to trade well-above the $4bn required to be within the S&P. Moreover the company will become more nimble and focused which is necessary given the recent innovations in the payment processing industry. It will have the option to go alone or to open itself to purse potential strategic partnership with other industry leaders due to the conflicts of interest with its parent eBay that were not able to be realized.

If millions of people are comfortable buying music, books and other items directly onto their devices, why would not they be comfortable skipping lines and saving time using a phone to make physical transaction at the POS? Well, there are already twelve million active users doing so when buying their coffee at Starbucks. It is likely then that the same patterns follows with the introduction of Apple and other recognized brands that are moving aggressively to become leaders in the mobile payment space. This will definitely be an important catalyst for the whole payment ecosystem in general. Whether or not some of the new entrants will become payments behemoths, it will be clear in the coming months and year. However, one thing is certain; in the short-term it does not matter how many players there are as long as there is another player out there popularizing the digital payment marketplace.

There is an extra positive sign that will definitely help achieve the so-needed broad base acceptance of offline payment and it could be the October 2015's deadline for US companies to shift to EMV – a key chip-based smart card standard necessary to enable payment at POS with handsets integrating the NFC technology.

Furthermore, PayPal has started to do moves into the $542bn market of remittance by partnering with one of the two market leaders last year; MoneyGram. It will be benefiting from over 35,000 agent locations across the US, along with its past expansion, it will muscle into countries like Nigeria, South Africa and Kenya. We believe PayPal can broaden its customer base and tap into the highly profitable remittance spaces.

"It is clear that the era of digital payments is upon us"

–John Donahoe, eBay's CEO

Finally, PayPal will have the option to sell to one of many interested parties. It would make an attractive takeover candidate for larger player that have long tried to build online payment platforms, as well as those trying to build a digital wallet but lack established partnerships and a customer base to that of PayPal. Even though these firms have a big chunk of cash to make large acquisitions, at an estimated EV of $32bn, PayPal would not come cheap – but less expensive without eBay woven into its valuation.

INSIDER OWNERSHIP

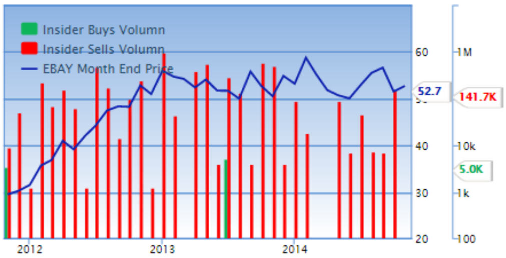
We believe eBay shares have experienced increased volatility this current year mainly due to factors affecting management such as: (i) shareholder activism from Carl Icahn that started a proxy fight to call for PayPal to spin out of eBay, (ii) managerial uncertainty, (iii) board inability to adapt to the rapid changing environment and (iv) its incapacity to attract and retain top talent.

In February of this year, ex-PayPal's president David Marcus wrote an email scolding over 13,000 PayPal employees at eBay's headquarters in San Jose for not using the company's app and now knowing their PayPal password. He was also outright against the deal with Samsung acknowledging it could jeopardize PayPal's status at that time as a "preferred payment processor" for Apple Pay. Those management's misalignments with the company could have triggered the reason for him to end up leaving PayPal for Facebook. After the split, current eBay CEO John Donahoe will not have an executive role at either company, nor will CFO Bob Swan. Both executives, however, will oversee the separation of the business and may join the boards of the companies.

The company has not been well-run one either. Since Danahoe took over the firm in March of 2008, eBay shares are up 100%. Over the same time period Amazon is up 385%; Visa and MasterCard are up 220% and 265% respectively. An example that has motivated this mismanagement could have been the disruption of synergies that took place in 2011 when Alibaba dropped its relationship with PayPal –in fear it would ultimately end up competing with eBay. Another example is of this mismanagement would be of industry leaders pursuing potential strategic partnership. These partnerships could have helped solidify PayPal's long-term relevance, and it would not have ended up prematurely if the firm were to be a standalone one.

Yet, for PayPal to become CEO Dan Schulman, 56, will bring his experience –on both payments and mobile technology– aligned with the firm's strategic focus on driving customer adoption of digital payments, partnering with merchants and innovating in mobile payments. It will further bring the opportunity for PayPal to reconstitute its other board directors and appointed board members who will not be conflicted with eBay anymore. Mr. Schulman has already proven to be a successful and passionate CEO. During his eight years at Virgin Mobile USA, he built the company from the grown up in 2001 to a public company eventually acquired in 2009 at a total value of $688m. Thereafter he built Priceline.com from a $20m business in annual revenue into a $1bn-a-year company. An example of the limits of his passion and understanding of his position, he spent 24 hours as a homeless person in order to put himself in the shoes of the less-affluent market, whom his team at American Express was targeting. With Mr. Schulman's new entry, he will bring the opportunity for PayPal to reconstitute its board of directors and appointed board members who do not have conflicts of interest with other companies. In addition, by PayPal

Source: GuruFocus.com



Source: GuruFocus.com

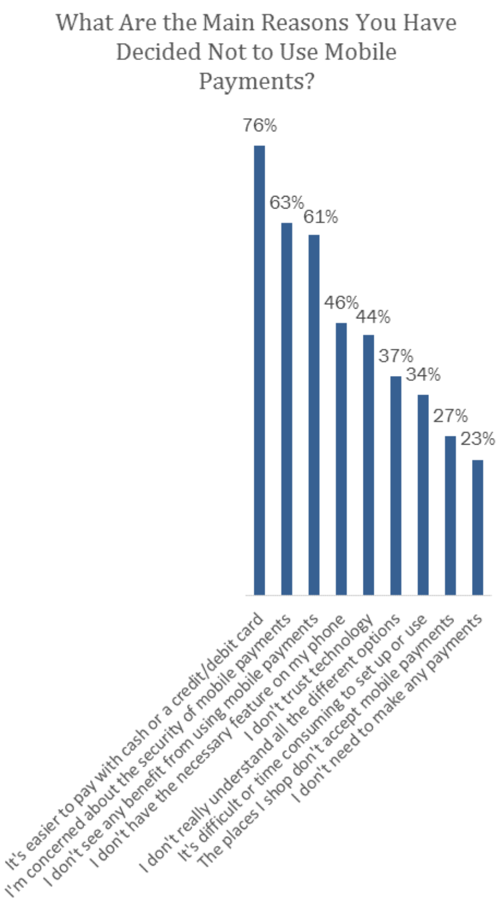
being a pure player and having its own independent and fully focused management team, it will be possible to make the best business-specific long-term operational, financial and business development strategies.

Furthermore the company would be much better positioned to motivate employees by developing an incentive plan tied to the operating performance of PayPal and help align the performance of its employees closely to the firm strategy. It will as well reverse its leak of talent by using its firm's stock as currency to attract new employees as well as keeping current ones more motivated in an independent company. PayPal could then focus on innovation, since management will no longer need to focus on supporting eBay's core marketplace business.

Currently the firm has no significant management ownership with 10% of the equity, down 9.33% in a six-month change. The stock is mainly owned by a large number of investment advisors accounting for 83% of ownership. However, the stock is owned by activist star Carl Icahn (4.7% of portfolio) and other meaningful investors such as Dan Loeb from Third Point, Seth A. Klarman from Baupost Group (3.6% of portfolio) and Mario Gabelli with its recently founded fund Gabelli Asset Fund (0.2% of portfolio). Regarding SEC F-4's, there is no relevant insider buying and most of the insider activity is stock options executions. Throughout the past two years, there has been high insider selling.

RISKS & MITIGATIONS

Risks



Source: Federal Reserve Bpard of Governors

Low awareness, understanding of benefits and availability among retailers, are among the key barriers of why mobile payments have not been widely adopted by customers in the US, according to a study published by the Federal Reserve Board of Governors.

Among those consumers who do not use mobile payments, the main reason they have not adopted the technology is that they see little value or benefit from using mobile payments: first, they state that 76% of their needs are already being met without mobile banking/payments. Second, they claim that they are comfortable with a non-mobile. Lastly, 61% reported a lack of well-defined value proposition. In summary, even when most consumers are aware of digital wallets, they do not really understand the core benefits of using it, and most of the time they end up going back to simplicity; the usage of cash and credit/debit cards.

Concerns about the security and privacy of mobile payments are also a significant reason why people do not use them (63%), as is a lack of trust in the technology (44%). Not having the necessary feature buried in their devices was cited by 46% of consumers, while 37% said that they do not understand mobile payments, and 27% said the places they shop do not accept mobile payments.

In conclusion, the greatest impediment to adoption of either mobile banking or mobile payments appears to be consumer's limited demand for them due to the points described above.

Mitigations

We consider that there currently exist big incentives to get retailers and customers to switch their payment system and start paying via their handsets – be it a smartphone, tablet or smartwatch.

Regarding the demand side, from all the FED survey's respondents said that they had concerns about security of paying using their mobile devices. However, most people have not used digital payment at POS so it's not clear how security might be a limitation. Built-in security features such as fingerprint scanner authentication in the latest Samsung devices –such as the Galaxy S5 and its smartwatch –,the encryption of the buyer's payment-card data (which prevent the seller to see the credit/debit card or bank account number), as well as other features stated in their Buyer/Seller Protection program should help alleviate some security concerns.

PayPal allows a variety of payment channels –P2P or money transfer, mobile payment and e-commerce– with a variety of payment methods: debt, credit, prepaid, gift cards, loyalty cards and coupons. It also allows for shopping comparisons, bringing event tickets, as well as obtaining transporting tickets.

Furthermore, using Braintree for paying with a mobile wallet is faster than swiping or tapping a card, since you only need to pay with your phone number and pin. Additionally, you can pay with a smartphone in order to skip the line, plus you get location-based offers thanks to Bluetooth low energy ("BLE") geolocation (see PayPal Beacon). Once in the store you have a real-time inventory search and you are able to use paperless coupons. After makin your payment, you can manage your money.

Growth in mobile payments at POS will be sustained with the number of NFC-enabled cell phones – which is reported to more than double in three years. Additionally, popular devices –such as iPhone 5S, 6 and 6+, Samsung Galaxy S5– that are NFC-enabled will definitely help start this momentum.

Regarding the supply side, there is an undoubted extra data value created by digital transactions that merchants can benefit from by creating an omnichannel space for consumers to have a better tech experience. Due to buyers past transactions, sellers can offer better services at much lower cost. They can target better products/services or coupons to the user with the data of the consumer's past transactions and geo-targeted mobile advertising.

As competition increases all players will converge to simplify and integrate payments, making it easier for employees (e.g. bartender, merchant, etc.) to use these payment methods. When will mobile payment reach mass adoption will depend on how quickly and how well concerns about mobile payment and its use case for the new technology is established by the players in the supple side (banks, payment networks and retailers).

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