KILLIK & Co

23 January 2012

Global Equity

.COMPANY:	EPIC:	MARKET CAP:	RECOMMENDATION:	RISK RATING:	PRICE:
Visa	V.N	$69.5bn	Buy Initiating Coverage	6 CATEGORY: UNRESTRICTED (see bottom of note for risk categories)	$99.33

Visa is the world's leading global payments technology company that enables consumers to use digital currency instead of traditional paper-based methods, such as cash and cheques. Visa does not issue cards, nor does it extend credit to cardholders, but generates revenue from the financial institutions that issue Visa-branded cards and from the merchants who accept them.

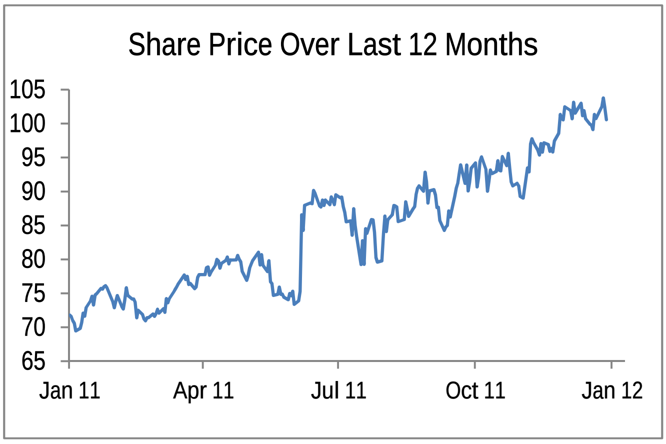
Investment Case

- Visa stands to benefit from the secular shift from paper-based payments towards electronic methods, driven by technological innovation and demographic shifts.
- Credit card penetration in emerging markets is expected to increase due to population growth, rising wealth levels, the financial inclusion of under-banked individuals, and the expansion of payment network infrastructure.
- The long-term outlook for the travel industry is very positive, and this is expected to lead to increasing cross-border transactions, on which Visa acts as processor, and from which it earns higher fees.
- The group has an attractive geographic bias, generating 58% of its revenues from the US, a region that is currently experiencing an improvement in macro-economic activity, and has a minimal exposure to the ailing eurozone.

Given its significant scale advantage, market share, and stronger margins – with a greater capacity for further expansion – we believe that Visa should be trading at parity, if not at a premium to MasterCard. Visa currently trades at a discount to MasterCard, at 17.0x consensus FY2012 earnings and 14.5x consensus FY2013 earnings, whilst MasterCard, trades on 15.8x FY2013 earnings. We initiate coverage with a Buy recommendation.

52 Week High	$104.20
52 Week Low	$69.35
Price to Book Value	3.1x
Dividend Yield	0.9%
Free Cash Flow Yield	6.5%
Dividend Cover	16.3x
Net Cash	$4.1bn
Interest Cover	170.7x
Emerging markets sales	40%
Next announcement	31 January 2012

Source: Company Data and Bloomberg Consensus



Note: UK investors may be subject to a withholding tax of 30% on dividends from US companies. Dividend yields are stated gross of this withholding tax. We do not automatically reclaim the withholding tax on investments held with us. This will reduce the amount of dividend income that you receive.

Year End	Sales ($m)	PBT ($m)	EPS ($)	PE (x)	DPS ($)	Yield (%)
Sep 2011	9,188	5,656	5.18	19.3	0.6	0.6
Sep 2012	10,062	6,037	5.85	17.0	0.9	0.9
Sep 2013	11,192	6,905	6.83	14.5	0.9	0.9
Sep 2014	12,203	7,713	7.86	12.6	1.0	1.0

Jonathan Jackson (Head of Equities)
Arjun Venu (Equity Analyst)
Nicolas Ziegelasch (Global Equity Analyst)
Mick Gilligan (Head of Research)

Unmistakably KILLIK & Co

Visa is the world's leading global payments technology company that connects consumers, businesses, banks and governments, enabling them to use digital currency instead of traditional paper-based methods, such as cash and cheques. Visa does not issue cards, nor does it extend credit to cardholders, but generates revenue from the financial institutions that issue Visa-branded cards and from the merchants who accept them. The group's 15,500 financial institution clients, operating in over 200 countries, had issued 1.9bn Visa cards as at 31 March 2011. In 2010, Visa cardholders spent $3.3 trillion over Visa's network.

Prior to its reorganisation on 3 October 2007, Visa operated as six distinct geographic units, which were owned and managed by its regional member banks with separate pricing policies. The reorganisation created a single global entity, Visa Inc., operating in five regions – the US, Canada, Asia Pacific, Latin America & Caribbean (LAC) and Central Europe, Middle East and Africa (CEMEA). The group floated on 19 March 2008, allowing it to compete more effectively on a global basis by aligning its pricing with its closest competitor, MasterCard, while also removing any perceived conflicts of interest by transferring majority ownership away from its financial institution customers. The sixth regional unit, Visa Europe, opted to remain independent as it pursued opportunities following the establishment of the EU's single Euro Payments Area (SEPA), a pan-European payment platform that enables customers to make cashless euro payments to anyone, anywhere within the eurozone.

Visa Provides Exposure to the Following Themes

- Technological Change – The shift to away from paper-based payments towards electronic payment systems is gathering pace, driven by technological advancement and demographic shifts. In the US, card-based payments are expected to have overtaken paper-based payments as a percentage of personal consumption expenditure by next year, driven, in part, by the continued growth of Internet retailing and the attractiveness of cards to the younger generation. New payment categories such as mobile payments and near field communication (NFC) are expected to grow rapidly.
- Emerging Market Growth – Credit card penetration is expected to increase due to population growth and rising wealth levels. Government initiatives aimed at accelerating economic growth, transparency and the financial inclusion of under-banked individuals will also drive the transition.
- Increased Travel – The longer-term outlook for the travel industry is very positive, driven by the increase in the size of an affluent emerging market middle class and the retirement of the baby-boomer generation in the West. This is expected to lead to an increase in cross-border transactions on which Visa act as processors, and from which Visa earns higher fees.
- Attractive Geographic Bias – The group generates 58% of its revenues from the US – a region that is currently experiencing an improvement in macro-economic activity – and has a minimal exposure to the ailing eurozone. It is also the largest network operator in Latin America, and has a significant market share in the Asia Pacific region.

How does Visa Make Money?

1. Visa's Role in Transactions

There are currently two types of card payment network, referred to as 'closed loop' and 'open loop'. Visa and MasterCard operate open loop networks, whilst the likes of American Express operate closed loop networks. In an open loop network, there are typically four external parties involved in the payment process:

1. The cardholder
2. The issuer – this is the financial institution which issues the credit/debit card to the cardholder.
3. The merchant acquirer – the bank or processor contracted by the merchant to process the transaction.
4. The merchant

Visa and MasterCard act as network operators, linking these four parties to process transactions.

2. Mechanics of a Transaction

1. The cardholder presents their card for payment at a merchant.
2. The merchant processes the card through a point-of-sale terminal.

3. The merchant acquirer obtains authorisation from the issuer over the payment network, and once the issuer authorises the transaction, a message is sent back to the merchant acquirer.
4. Once authorised, the merchant acquirer ‘acquires’ the transaction and pays the merchant the purchase price, less a discount rate, referred to as the ‘merchant discount’.
5. Post-transaction, the merchant acquirer and issuer clear the transaction through the payment network.
6. Settlement then occurs between the issuer and merchant acquirer, with the issuer paying the merchant acquirer the transaction price, less a stated rate, known as an ‘interchange’ rate.

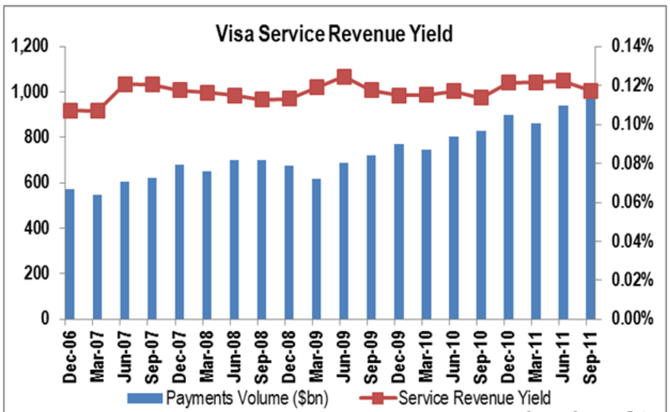
In order to understand the economics of such a transaction, below is an illustrative example. Assuming a £100 purchase price, a merchant discount rate of 2.25% and an interchange rate of 1.75% and the absence of any third party processors:

1. The cardholders’ account is charged with £100.
2. The merchant receives £97.75.
3. The merchant acquirer takes a merchant discount of £2.25, remitting a £1.75 interchange to the issuer out of this.
4. From its £1.75 interchange revenue, the issuer pays a processing fee of £0.10 to the network operator.
5. From its gross £0.50 revenue, the merchant acquirer pays a fee of £0.05 to the network operator.
6. From the merchant discount of £2.25, the issuer receives £1.65 of net revenue, the merchant acquirer receives £0.45 of net revenue and the network operator (e.g. Visa) receives £0.15 of net revenue.

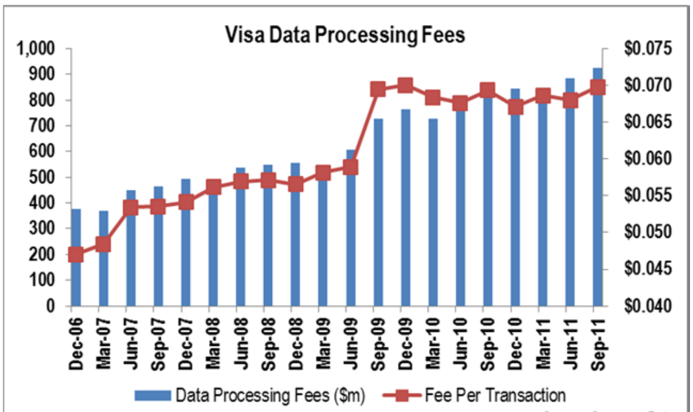
Visa sets the interchange rate, but does not earn interchange fees, which represent the bulk of the merchant discount and are paid to the issuer, which bears the risk of non-payment from the cardholder. Visa instead earns fees for administering the collection and remittance of interchange through settlement, which ultimately represent only a small percentage of the merchant discount. In reality, transaction fees are usually more complex than in the example above, but are generally based on the dollar volume processed. The interchange and amount retained by the merchant acquirer can vary widely depending on factors such as the purchasing power of the merchant, and whether the transaction involves a credit or debit card. Debit card transactions carry lower interchange fees, as the purchase amount is debited from the cardholder’s bank account immediately as opposed to at the end of a billing cycle. Within debit card transactions, signature transactions carry higher interchange fees than PIN transactions, as PIN transactions are typically more secure and issuers therefore have less to pay in security and fraud prevention fees. In a closed loop network, network operators act as both the issuer and merchant acquirer, and although exposed to credit risk, they are able to charge higher interchange and processing fees – receiving the entire merchant discount.

3. Visa’s Revenue Categories

Visa generates fees from customers, which vary by product type and are customised for each client through incentive agreements. In FY2011, Visa generated gross revenue of $11.1bn, up 15% year-on-year. Visa has four major revenue lines: service fees, data processing fees, international transaction fees, and other fees.



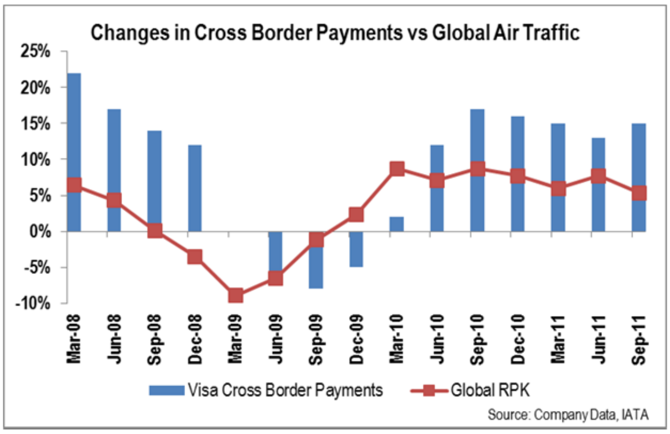
Source: Company Data

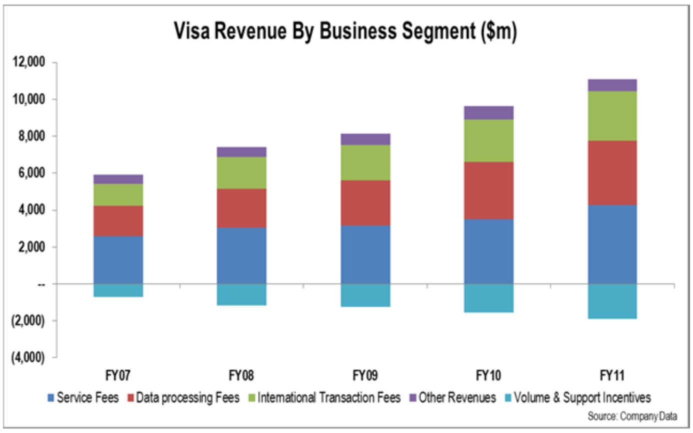


Source: Company Data

Service fees represent the largest contribution to group revenue. Issuers and merchant acquirers pay service fees, based on the prior quarter's total payment volume (i.e. the total monetary value of purchases made using Visa's cards). These fees are assessment fees payable for using and accepting Visa-branded card products, with the exception of PIN-based debit cards. Also included within this category are acceptance fees, which are used to support merchant acceptance in order to grow volumes.

Visa's next-largest revenue line is data processing fees, paid by issuers and merchant acquirers for the authorisation, clearing and settlement services provided by Visa's VisaNet network and the CyberSource e-commerce payments gateway, which enables merchants to accept payments online. These fees are based on the number of transactions processed over the current quarter. Additionally, Visa earns fees for sending transactions across PIN debit networks, and providing other services such as risk management and designing customer loyalty programmes. In the US, Visa processes most of its transactions over its own network. However, outside of the US, the banking system is less fragmented, with fewer banks within any particular region, most of which act as both issuers and merchant acquirers, allowing them to process and settle transactions themselves.





Visa generates international transaction fees for payments where the issuer is domiciled in one country and the merchant in another, and on overseas cash withdrawals. These fees are a percentage of transaction value, and are hence driven by cross-border payment volumes in the current quarter. Although, as stated above, Visa may not process the majority of its domestic transactions outside of the US, the group processes virtually all of its transactions in which the merchant and issuer are located in different countries. When a cross-border transaction occurs, Visa will also charge a percentage of the purchase price for currency translation, which is passed onto the cardholder by the issuer. In addition, Visa charges a fixed International Service Assessment fee on all transactions, regardless of whether it performs a currency conversion.

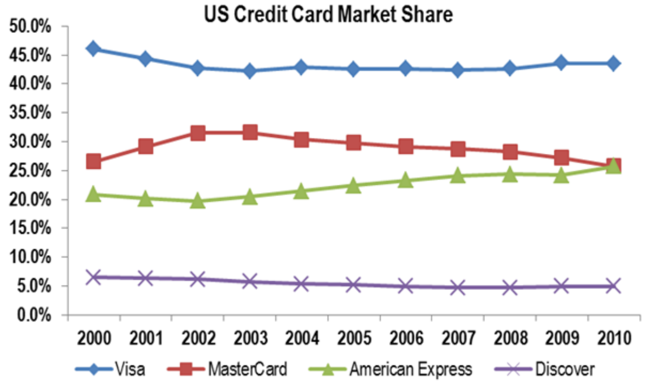
Although Visa does not publish its cross-border payment volumes, the group has indicated that they represent less than 10% of global payment volumes. However, international fees represented 24% of gross revenues in FY2011, suggesting a higher revenue yield than for other categories. International fees have been influenced significantly by increased levels of overseas travel, ongoing globalisation and by the security and ease of using Visa-branded cards for international transactions.

Visa also receives revenues for optional value-added services, and earns a licencing fee from Visa Europe for the use of its brands and ongoing transaction services. These items are consolidated into 'other' revenues. Visa also returns a portion of its revenues to its issuers and merchant acquirers to incentivise them to generate certain payment volumes on its network, payable on an ongoing quarterly basis. These incentive payments act as contra-revenues, made in the form of rebates, cash payments or marketing services on contracts ranging from 12 months to 13 years. In FY2011, Visa's volume and support incentives amounted to 17% of gross revenue. Going forward, this percentage is forecast to increase, driven by increasing incentives to overseas clients in emerging markets, increased rebates on higher absolute payment volumes as card usage rises, and competitive pressures.

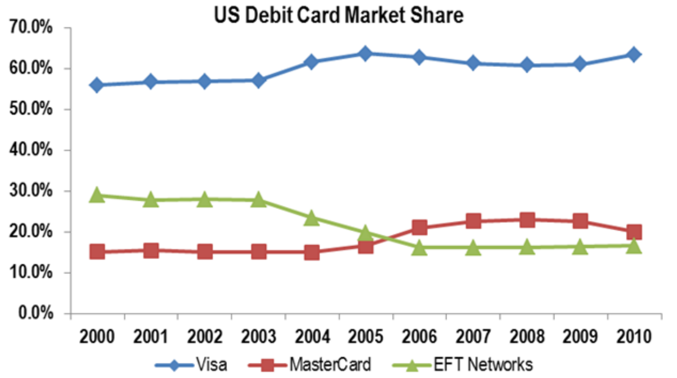
The Global Cards Market

The US is Visa's largest market, representing 57% of the group's payment volumes in CY2010, and 58% of operating revenue. The group is the market leader by payment volume in both credit and debit cards, with a market share of 44% in credit cards (MasterCard:

26%; American Express: 26%) and a 63% share of debit cards (MasterCard: 20%). Visa's market position is a result of its leading global brand name, long-standing relationships with the top card-issuing financial institutions, and its robust processing network.



Source: Company Data, The Nilson Report



Source: Company Data, The Nilson Report

Both Visa and MasterCard enjoy substantial relationships with some of the biggest card issuers in the US, with large US financial institutions representing a significant proportion of their payment volumes. Although card issuers tend to diversify their portfolios between different brands, looking at Visa and MasterCard's payment volumes it is clear that issuers tend to have a preferred network.

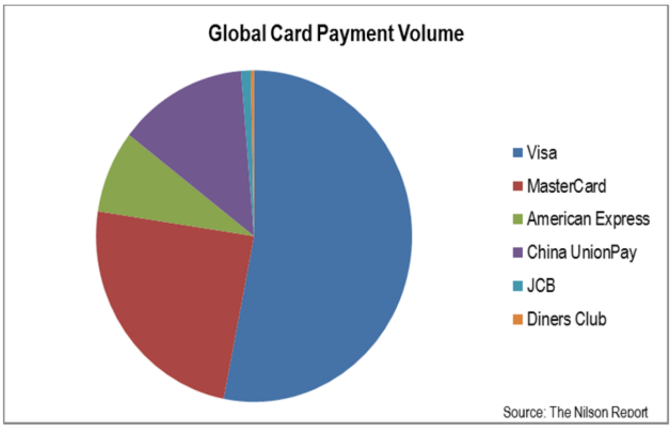
In credit cards, Visa's key relationships include those with JPMorgan Chase and Bank of America. The loss of a large client could result in a material fall in fee revenues, given that in 2010 Visa's top 10 clients accounted for 81% of its US credit card payment volume, while MasterCard's top 10 clients accounted for 86%. In debit cards, Visa's market position is underlined by the fact that of the top 10 card issuers in the US – which account for just under half of all payment volumes – Visa is the preferred network for 7 issuers, including all of the top 6. Although there has not been the level of consolidation in the US banking sector as seen in the aftermath of the financial crisis, issuer consolidation would have implications for US market share. However, given Visa's position as the preferred brand for many of the largest credit issuers in the US, it has historically benefited from M&A within the sector.

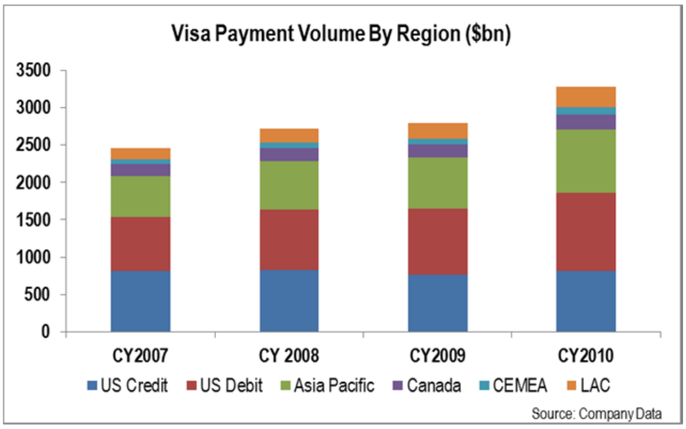
Visa's strong position in US debit cards is of particular importance, given the stronger growth rates seen in debit card payment volume relative to credit card payment volume. Following the placement of a cap on debit interchange fees (discussed below under *Regulatory Issues*), Visa is coming under increased pressure, and MasterCard recently confirmed that it had won the signature debit card business of Huntington Bank, the 26th-largest debit issuer in the US. Given Huntington's purchase volume of around \$6.7bn in 2010, this does not represent a meaningful loss to Visa – with EPS expected to be affected by less than 1c, or around 0.1%. Although it is unclear what incentives MasterCard has offered in exchange for Huntington, it is worth noting that MasterCard's client incentives in the three months to 30 September were 23.7% of gross revenue, compared to 19.5% for Visa over the same period.

Visa has made a concerted effort following the debit interchange legislation, offering higher incentives for both merchants and merchant acquirers, revised network participation fees and other variable pricing efforts for merchants, underlining its intention to protect its market share. This has proved successful, with the momentum MasterCard had gained in winning US debit business in 2010 with banks such as Santander's Sovereign Bank and SunTrust having stalled, and Huntington the only issuer of note signed in 2011.

Outside of the US, Visa enjoys leading market share positions across almost all geographic regions, with the sole exception being Asia Pacific, where it is the second-largest operator behind China UnionPay. This is because neither MasterCard nor Visa are permitted to operate as a payment network in China, with China UnionPay the only current operator for domestic transactions. However, both groups are currently able to act as processors for cross-border transactions on purchases made overseas by Chinese nationals.

The group is seeing strong growth in Asia Pacific, CEMEA and LAC, although in these regions Visa's payment volume growth has been driven by a handful of key markets, which tend to be more developed, such as Brazil, Japan and Korea. However, in some of the more populous regions in which the group operates, such as India, Turkey and Indonesia, card penetration remains very low. Visa therefore stands to benefit as credit card issuance proliferates in these regions, driven by growing demand for consumer finance grows. International markets are expected to make up an increasing mix of Visa's payment volume and revenue going forward.





Competitive Advantage

Visa enjoys significant barriers to entry relative to its competitors in the global payments industry, due to its vast network of financial institution issuers and merchants who accept its cards, in addition to its global brand name and its global processing platform, which has significant unutilised capacity. Visa reported a payment volume of $3.3 trillion in CY2010, compared to a payment volume of $2.0 trillion for MasterCard, its only real competitor in terms of scale. The number of transactions processed by Visa last year amounted to 47.1bn, compared to 23.1bn for MasterCard. This scale advantage has allowed the group to generate industry-leading margins: in FY2011, Visa generated an EBIT margin of 59.4%, 9.7 percentage points higher than MasterCard.

Outlook for Fees

Both Visa and MasterCard are expected to see increased pressure on fees in the medium term, particularly on their service and data processing revenues, as competitors emerge, and as large issuers outside of the US reach volume thresholds that incur lower prices under their agreements with Visa, as card issuance in emerging markets continues to grow. Service fees will also come under pressure if merchants phase out acceptance of signature debit in favour of PIN-based cards. Revenue growth from international transactions is expected to outpace growth in service and data processing, driven by further growth in cross-border payments as international travel increases in popularity and affordability in emerging markets.

Margin Expansion

However, the group has the potential for margin expansion, with significant unutilised capacity on VisaNet, enabling the group to capture further growth in transaction volumes without any additional cost for its network. In addition, Visa has also demonstrated its pricing power since 2007. For example, Visa's data processing fees have seen two material increases in recent years. In the quarter ended June 2007, Visa amended its fees to reflect its transition into a single global business model. Then, after the quarter ended June 2009, the group introduced an acquirer processing fee of 1.95c for all US authorisations.

Historically, the group has also driven margins through lower marketing expenses, cutting the number of sponsorships to focus on FIFA, the NFL and the Olympics, lowering regional budgets, transitioning its focus from TV to digital advertising and increasing the proportion of marketing expenses that are discretionary. The group's scale advantage allows it to operate as a low cost service provider, affording it the ability to protect its market share, while its margin advantage provides it with the opportunity to invest in new technologies in order to capture growth as global consumer spending shifts away from paper-based transactions.

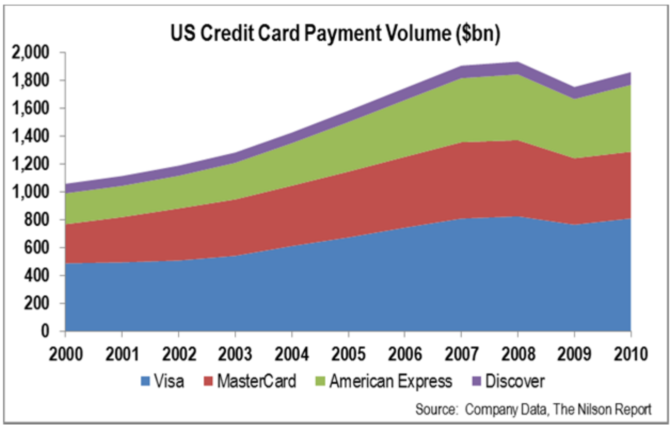
Secular Growth

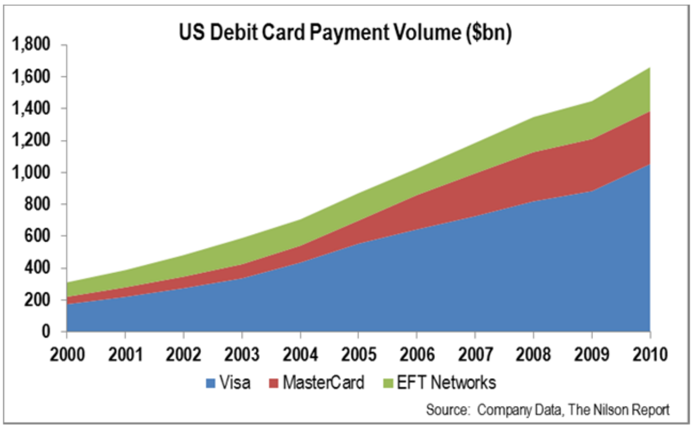
1. The Shift away from Paper-Based Transactions towards Electronic Payments

In addition to competing against peers such as MasterCard, Visa competes against other payment forms, such as paper-based payments like cash and cheques – which still account for some 85% of global transactions – in addition to other electronic payment methods, such as eBay's PayPal. As Visa earns fees based on card-based transactions, its growth is tied to growth in global PCE, increased merchant acceptance and increasing card usage as a proportion of PCE.

Card payment volumes have been growing at a greater rate than PCE in recent years, whilst the proportion of purchases made using traditional methods has been declining. According to The Nilson Report, a leading periodical which covers the payments industry, card-based payments are expected to have overtaken paper-based payments as a percentage of PCE by next year in the US, as increased levels of merchant acceptance and demographic shifts drive the substitution of traditional paper-based payment methods.

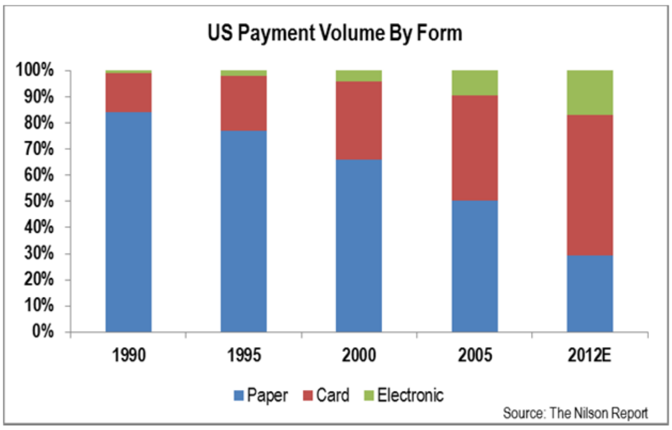
In particular, the use of debit cards – in which Visa is the market leader – is expected to drive growth in card usage going forward as they are increasingly used for non-discretionary spending. Although the fees received from debit card usage are slightly lower, the increased use of debit cards in place of cash for smaller purchases and by consumers who do not qualify for credit cards provides a significant revenue opportunity. In the US, rising merchant acceptance following regulatory reform on debit interchange rates (discussed below under *Regulatory Issues*) will also drive growth.

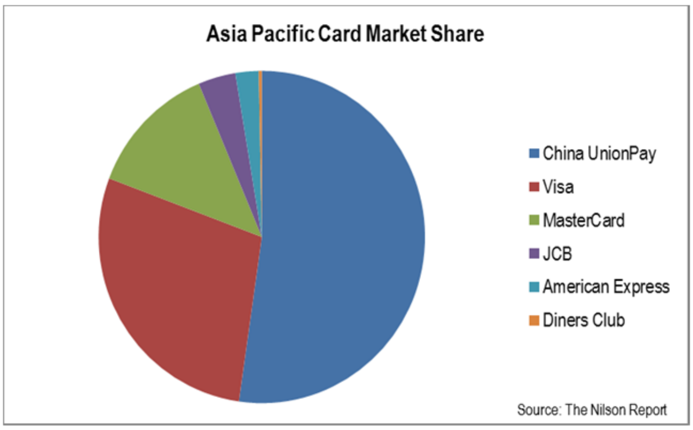




Demographic shifts are also driving card usage. Younger generations tend to be more comfortable with card usage, given that they have been increasingly exposed to new technologies and card-based transactions have been common for a greater portion of their lives, and the convenience, security and loyalty benefits offered by cards. Additionally, the lack of cash alternatives for internet transactions further plays into the hands of providers of card and electronic transactions.

Card volumes are also expected to benefit from the increasing prevalence of prepaid cards, which will gradually lead to shifts in consumption away from paper-based transactions for under-banked, cash intensive consumers. Visa currently offer a wide range of both disposable and reloadable prepaid cards, aimed at under-banked consumers who may not qualify for traditional credit and debit cards, younger consumers, tourists – as a replacement for travellers' cheques – and as gift cards.





2. International Growth

Additionally, Visa stands to benefit from a significant international growth opportunity. In FY2011, 45% of payment volumes and 44% of group revenue came from international markets, although payment volumes have grown 93% since FY2007, compared to growth of 35% in the US. In mature economies in Asia Pacific and LAC, growth will be focused on increasing wallet share and introducing new technologies. However, in emerging economies growth will be focused on the expanding numbers of under-banked consumers and the rapid expansion of electronic payments infrastructure.

Card usage and penetration in Visa's international markets is considerably lower than in the US, with less than one card per capita held in the CEMEA, LAC and Asia Pacific regions, compared to more than three in the US. Although card penetration is unlikely to reach similar levels to the US in these emerging markets, the combination of faster population growth, rising wealth levels and the development of modern payment systems is expected to provide a significant revenue opportunity for Visa.

Additionally, the US has asked the WTO to look into opening the Chinese payment market, which represents a significant proportion of Asia Pacific payment volume, and reached over $1 trillion in 2009. The potential opening of this market to new entrants would provide a particularly strong growth opportunity, given Visa's scale advantage over its peers and strong brand, in a market which the Boston Consulting Group estimates will grow at an annual rate of 17% over the next decade.

3. Emerging Payment Technologies

New technologies will help to drive further growth, with Visa seeking to increase its presence in emerging payment categories such as mobile payments and e-commerce. The group has adopted a strategy of acquisitions and partnerships in a foothold in these segments. Notable acquisitions include CyberSource and PlaySpan in e-commerce, and Fundamo, an emerging markets mobile financial services company. Strategic partnerships include those with DeviceFidelity, which enables smartphones to engage in point-of-sales transactions using NFC technology, Visa's long-standing relationship with Monitise, a leading mobile banking and payments company, and the recent global licence signed with Google for the NFC-based Visa payWave, which will allow Google Wallet users to store Visa account data. VisaNet's strong competitive position means that it will be well placed to capture processing revenues from increased levels of NFC-based payments as mobile wallets lower the need for consumers to carry cash.

In May, Visa also announced its intention to launch a digital wallet that will allow consumers to engage in mobile transactions, use click-to-buy features in e-commerce, consolidate multiple Visa and non-Visa accounts and receive merchant-funded discounts on purchases via their phones. Additionally, the group confirmed in August that it would be accelerating the migration to EMV (the de facto global standard in chip technology created by Europay, MasterCard and Visa) contact and contactless chip technology – as opposed to traditional magnetic strips – in the US in order to help develop payment infrastructure for the arrival of NFC-based mobile payments.

Litigation Issues

Prior to its flotation, Visa established a Retroactive Responsibility Plan (RRP), an escrow account from which liabilities under certain 'covered' litigation in the US can be paid. The RRP established a loss-sharing agreement with its US bank members, in order to protect holders of the publicly traded Class A shares. Under the terms of the RRP, when Visa makes deposits into the escrow account, the Class B shares held by its US member banks are subject to dilution through an adjustment to the conversion rate between Class B shares and the Class A shares. This has the same EPS impact as repurchasing the Class A shares, by reducing the as-converted Class B share count, so as not to dilute the holdings of ordinary Class A shareholders. The group has a number of pending litigation issues, chief amongst them the merchant interchange litigation, which began in 2005, in which complaints were made against Visa and MasterCard over their setting of interchange rates, seeking damages. These damages would be subject to trebling should wilful intent be proven, which could range in the tens of billions of dollars – shared between Visa, MasterCard, and their regional member banks.

Regulatory Issues

Revenues at Visa and MasterCard will be affected by the Durbin Amendment to the Dodd-Frank Act, which sought to cap debit interchange fees and eliminate network exclusivity for processing debit card transactions. The Federal Reserve has issued a cap of around 23 cents (21 cents base plus 1 cent for fraud prevention expenses and a 5 basis point duty), an improvement from the 12 cents initially proposed. The interchange cap will not apply to any financial institution with less than $10bn of assets, nor for prepaid debit cards. Additionally, the Fed has mandated that merchants must have the option to use at least two unaffiliated brands to process debit card transactions. The interchange cap became effective in October, with the network exclusivity prohibition taking effect next April.

The group has outlined its new debit interchange rates, which will effectively bring PIN and signature debit interchange closer to parity. This is not expected to drive significant mix shifts in the near-term. There have been recent reports of Senator Durbin seeking similar regulation on credit cards, but there does not appear to have been much appetite for any reform from Senate.

Visa Europe Put Option

In 2007, Visa Europe opted against incorporating itself into Visa, remaining independent from the group and owned by its members. At the time of the IPO, Visa put into place a put agreement, which if exercised by Visa Europe would require Visa to purchase the entire share capital of Visa Europe. The agreement states that the purchase price would be determined by applying Visa's forward PE multiple to Visa Europe's sustainable net income, adjusted for an agreed share of any cost synergies. Visa Europe is not expected to exercise this option. We would expect any potential acquisition of Visa Europe to cost in the region of $3.8bn.

Financial Considerations

On 26 October 2011, the group reported its fourth-quarter results, with EPS of $1.27, ahead of consensus estimates despite the $0.03 impact of restructuring expenses, with net revenue slightly below consensus forecasts, up 13% to $2.4bn, due to one-off incentives around debit interchange regulation. For the full year, net revenue was up 14% to $9.2bn. Service revenues were up 22%, with data processing revenues up 11% and international transaction revenues up 17%. Client incentives were up 80 basis points, to 17.0%, driven by the final quarter increase. Net income, adjusted for the revaluation of the Visa Europe put option, was up 22% to $3.5bn, equivalent to an EPS figure of $4.99. The full-year operating margin was up 250 basis points, to 59.4%.

The group has a strong balance sheet, with no long-term debt and total available liquidity of $6.9bn exclusive of its litigation escrow account, enabling it to further strengthen its shareholder returns. The group paid $423m via dividends in FY2011, at a rate of $0.15 per share, and recently increased the payout by 43% to $0.22 per share. The group has returned $2bn to shareholders via share buybacks, and on 26 October extended its approved buyback programme by $1bn, to $1.6bn.

The funding of $1.2bn into the litigation escrow account in FY2011 acted as a further effective shareholder return, and was supplemented on 23 December by a further $1.565bn, using funds from the share buyback programme, providing a further uplift to expected FY2012 EPS. The litigation reserve is expected to stand at over $4bn at quarter-end, and although Visa has now largely exhausted the $1.6bn available for its existing buyback programme, its strong capital management means another programme is likely.

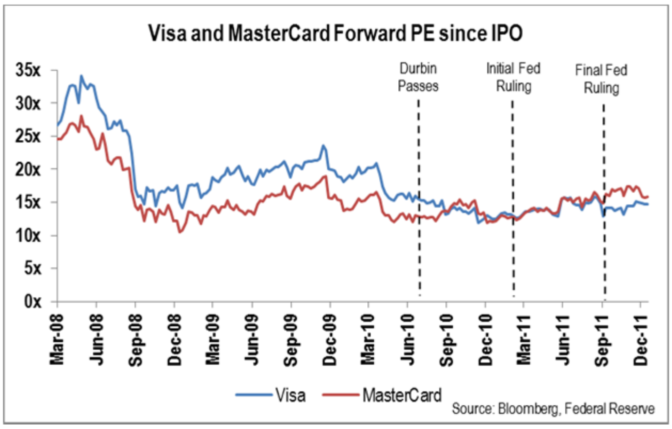
The group has also provided its financial outlook for the following for FY2012. Net revenue growth is expected to be in the high-single digit to low-double digit range, with EPS growth in the mid to high teens. Operating margins are expected to remain stable at around 60%, with client incentives expected to be 17%-18% and marketing expenses remaining under $1bn during an Olympic year. Free cash flow is expected to be in excess of $4bn in line with FY2011. Taking into account around $600m in dividend payments and further expected share repurchases, Visa should be able to retain at least $1.8bn of free cash flow before acquisitions.

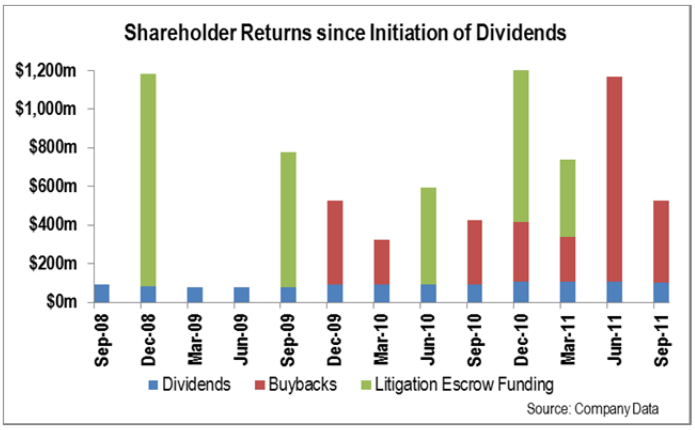
Valuation

The group's only real direct comparative is MasterCard, given that other large rivals such as American Express and Discover operate closed loop networks. After its IPO, Visa traded at a premium to MasterCard until concerns over debit interchange regulation entered the equation, at which point negative sentiment led to a re-rating as investor concerns grew over whether Visa could lose market share in US debit. Visa's pricing strategy has proved successful, with MasterCard's momentum in winning US debit business stalling, and although some minor dilution to earnings is expected in FY2012, growth is expected to reaccelerate in FY2013.

Although the wide premium Visa used to trade at relative to MasterCard is not expected to re-emerge, we believe that Visa should be trading at parity, if not at a slight premium to MasterCard, for a number of reasons. Firstly, the group's dominant market share leaves it well positioned to benefit from growth in payment volumes. The group still maintains a healthy position in debit and credit cards in the US and overseas, and in the fast-growing Asia Pacific region, excluding China the group is the market leader, with a share more than double that of MasterCard. Visa's dominant position is underlined by its $3.7 trillion global payment volume in the twelve months to 30 September, 56% greater than MasterCard's $2.3 trillion.

Secondly, Visa's scale advantage has enabled it to generate operating margins significantly higher than MasterCard's, and the significant unutilised capacity on its processing network should enable it to further expand its margin. Additionally, Visa has greater flexibility to adjust its marketing spending – whereas its $870m in marketing equates to only 9.4% of net revenue for FY2011, MasterCard has spent 12.9% of its revenue over the same period on customer acquisition, and given its focus on gaining market share it has less flexibility on reducing any future marketing spend. Despite the increase in client incentive payments made by Visa over the most recent quarter, incentives as a proportion of gross revenue remain low, at 17% for FY2011, compared to 29% for MasterCard. It is also worth noting that MasterCard's service revenue yield and processing fee revenue per transaction are higher than Visa's, meaning that price increases may be harder for it to put through in search of market share gains.





Thirdly, Visa offers superior returns to shareholders. Since 2008, the group has returned over $1.2bn through its quarterly dividends – with a further $600m expected to be paid in FY2012. In addition, the group has returned over $3bn via on-market share buybacks, with a further $1.6bn in buybacks authorised, and the group has also effectively repurchased $3.5bn through the funding of its litigation escrow account. Visa's RRP also leaves it better insulated against any large litigation settlements, unlike MasterCard who do not carry a similar provision.

Visa currently trades at a discount to MasterCard, at 17.0x consensus FY2012 earnings and 14.5x consensus FY2013 earnings. Its move to a discount relative to MasterCard, which trades on 15.8x FY2013 earnings, has been driven almost completely by negative sentiment regarding Visa's ability to hold onto its share of the US debit card market, which appear somewhat overdone. With recent clarity on the post-Durbin environment, Visa's shares are expected to move back to a rating that is at least at parity with MasterCard.

Risks with this recommendation

- Emerging market growth is impeded by cards remaining underpenetrated, or the emergence of a local competitor.
- Ongoing litigation results in a settlement larger than provisioned for in the group's litigation escrow account.
- Interchange legislation, such as the Durbin Amendment to the Dodd-Frank Act, could result in lower fees.
- Emerging payment technologies lead to lower margins through shared economics or disintermediation.

KILLIK & Co RESEARCH RECOMMENDATIONS					
Equity Research			*Fund Research*		
Large Cap	*Mid Cap*	*Global*	*Absolute Return*	*Income*	*Growth*
Investment ideas in the FTSE 100 which we believe will generate returns ahead of the All-Share index.	*Investment ideas in the FTSE 250 which we believe will generate returns ahead of the All-Share index.*	*Global investment ideas which we believe will generate returns ahead of the FTSE World (ex UK) index over the long term.*	*Funds that aim to generate an absolute return over the medium to long term, i.e. a positive return irrespective of equity or bond market direction.*	*Income producing funds, which are attractive in the context of the yield available from cash, gilts and UK equities.*	*Funds which we believe have the potential to generate a high level of capital growth over the long term.*

KILLIK & Co RESEARCH PERIODIC PUBLICATIONS		
Daily Note	*ETFs Bulletin*	*Thematic*
A summary of the day's newsflow and an update of opinion on covered stocks.	*Focusing on London-listed Exchange Traded Funds (ETFs) and Exchange Traded Commodities (ETCs).*	*A number of direct equity and fund ideas that are well positioned to exploit a key investment theme.*

The Killik & Co Research Policy and recommendation definitions can be found at www.killik.com/research

The Killik & Co Risk Rating system uses categories which are intended as guidelines to the specific risks involved, as follows:
Restricted Lower Risk (1), Restricted Medium Risk (2-3) and Unrestricted (4-9).
Please see the Killik & Co Terms & Conditions for further detail.

Disclaimers