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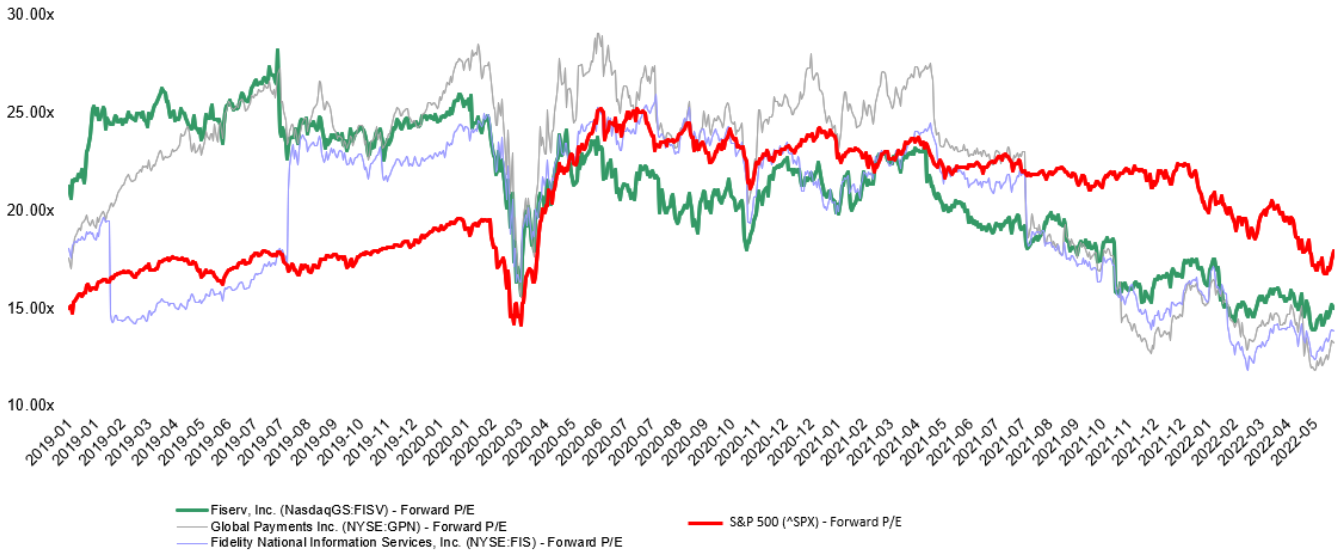
Note: All dollar figures are $US unless stated otherwise.

Introduction

The share prices of the legacy payment processors—**Fiserv** (FISV), **Fidelity National** (FIS) and **Global Payments** (GPN)— have declined considerably over the past two years. Historically, these companies traded at a premium to the market but are now trading at a material discount.



Source: Capital IQ, GreensKeeper.

The recent selloff has largely been due to the prevailing narrative that the legacy processors are facing disruption from innovative newcomers like **Adyen**, **Block/Square** (SQ) and **Stripe**. We acknowledge that the challengers are growing fast and taking some market share. However, they are materially smaller and the industry itself continues to grow as do the legacy players (just not as fast).

Our preferred investment in the sector is Fiserv due to the company's leading market share, bank relationships and FISV's ownership of Clover (SMB) and Carat (enterprise) which we believe positions them to successfully respond to this new competition.

With the stock currently trading at $100.13, we believe it is undervalued and derive an intrinsic value of $142 based on a 20X multiple of our 2023 projected free cash flow. With a solid balance sheet, secular tailwinds and EPS growth in the mid teens, we believe FISV offers an appealing investment opportunity and target a 19% IRR on our investment over the next few years.

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Company Overview

Fiserv operates in three segments. The Merchant Acquiring segment provides merchants with the ability to securely accept electronic payment transactions from consumers around the world. Fiserv sells its Clover and Carat products across a wide range of distribution channels including direct sales, independent software vendors (ISVs), Financial Institutions (FIs), and joint ventures with bank customers.

Fiserv's Payments and Networks segment provides FIs and corporate clients that issue payment cards with the services required to process payment transactions. Fiserv processes various card transactions including debit, credit, and prepaid cards. The company also offers a broad range of capabilities including bill payment, non-card digital payment, peer-to-peer (P2P) payments, and account to account (A2A) transfers.

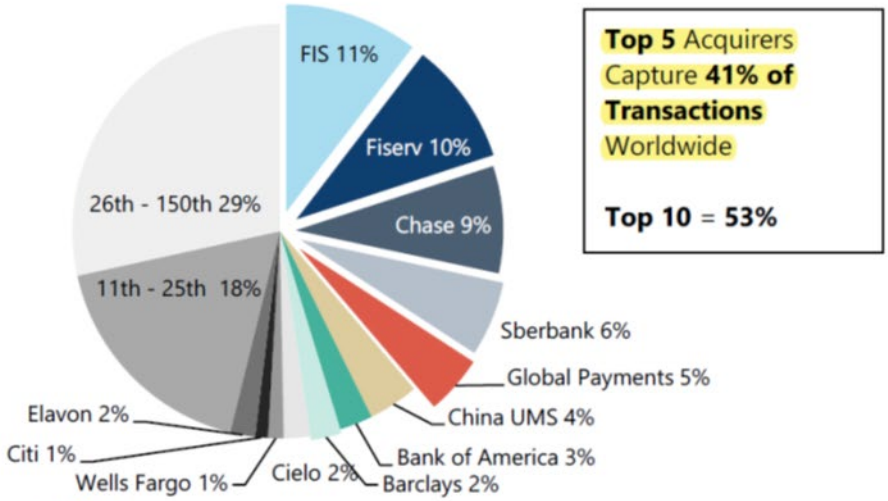
Finally, Fiserv's Fintech segment provides FIs with the technology they need to process deposit and loan accounts as well as manage their general ledger. Fiserv also offers risk management solutions and a variety of other services to banks to complement the core account processing functionality.

Merchant Acquiring Segment

The payment processing industry is heavily consolidated, with the top 10 merchant acquirers capturing 75% of bank card purchase volumes.

Exhibit 17 - Worldwide Acquiring Market Share (2019) Highly Concentrated at Largest Players

Top 10 account for 53% of transactions worldwide, and likely a greater share of revenue



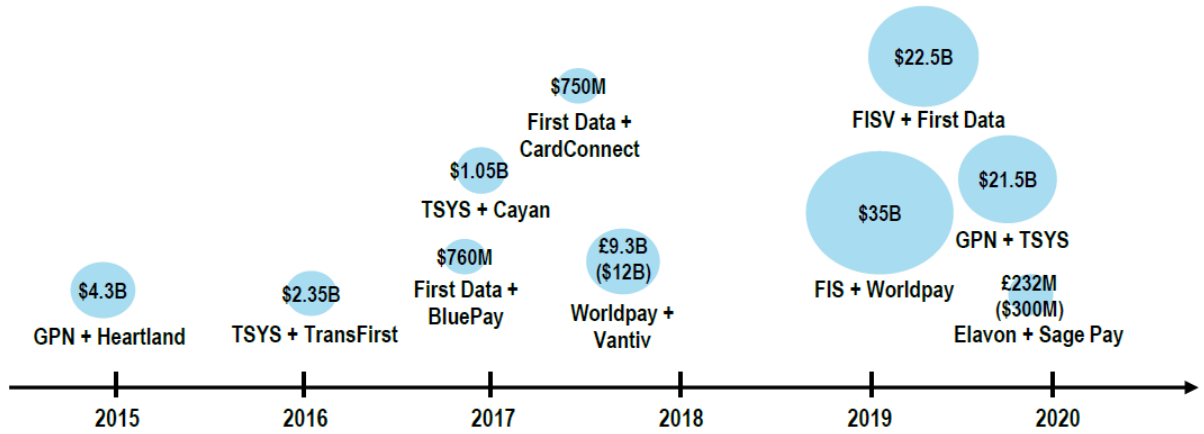
Source: Nilson Report, Jefferies

Note: Fiserv includes ratable share of BAMS, Wells Fargo, Citi, Santander, SunTrust, and BBVA

Scale is vital to success in the industry and forms the largest part of a payment processors' competitive moat (along with switching costs and intellectual property). Once a payment processor achieves scale, the incremental cost to process additional transaction volume is low and incremental volume delivers a high marginal contribution. As a result of this dynamic, the industry underwent a further round of consolidation recently (see diagram below) with FIS, FISV and **Chase** currently the top three players.

Exhibit 16 - Recent M&A Reshaping the Merchant Acquiring Industry...

Time of deal announcement



Source: Jefferies, FactSet, Company Data

An important part of our investment thesis is that merchant acquisition is not a zero-sum game. In 2021, **Visa's** (V) and **Mastercard's** (MA) volumes increased by 20% to $18,100b while Stripe, Adyen, and Square combined accounted for only $1,177b (or ~6.5%) of volume. The table on the following page compares the processing volumes of selected industry participants.

The current small market share of the innovative newcomers leaves plenty of market growth for legacy acquirers to capture. Payment volume growth is expected to continue as there are an estimated 20 million merchants in the US alone who do not currently accept card-based payments.

GPV (Billions)				
Company	2019	2020	2021	CAGR
VISA MasterCard	$15,300	$17,200	$18,100	9%
fiserv.	$2,900	$3,100	$3,700	13%
clover	$23	$88	$200	195%
FIS	$1,723	$1,756	$2,104	11%
globalpayments	$757	$726	$900	9%
adyen	$240	$304	$516	47%
Square	$106	$112	$161	23%
stripe	$150	$350	$640	107%

Source: Company Reports, GreensKeeper.

National banks still represent about 38% of the industry in the US, while scale legacy processors (FISV, GPN, FIS) serve 28%, and regional banks and Fintech companies (Square, Adyen, Stripe) combine for the remaining share. Fiserv has exposure to all three segments through the formation of joint ventures with their bank customers. JV relationships broaden distribution and allow Fiserv to sell merchant acquiring to other parties without having to replicate the JV partner's payment processing infrastructure.

Fiserv's Competitive Positioning

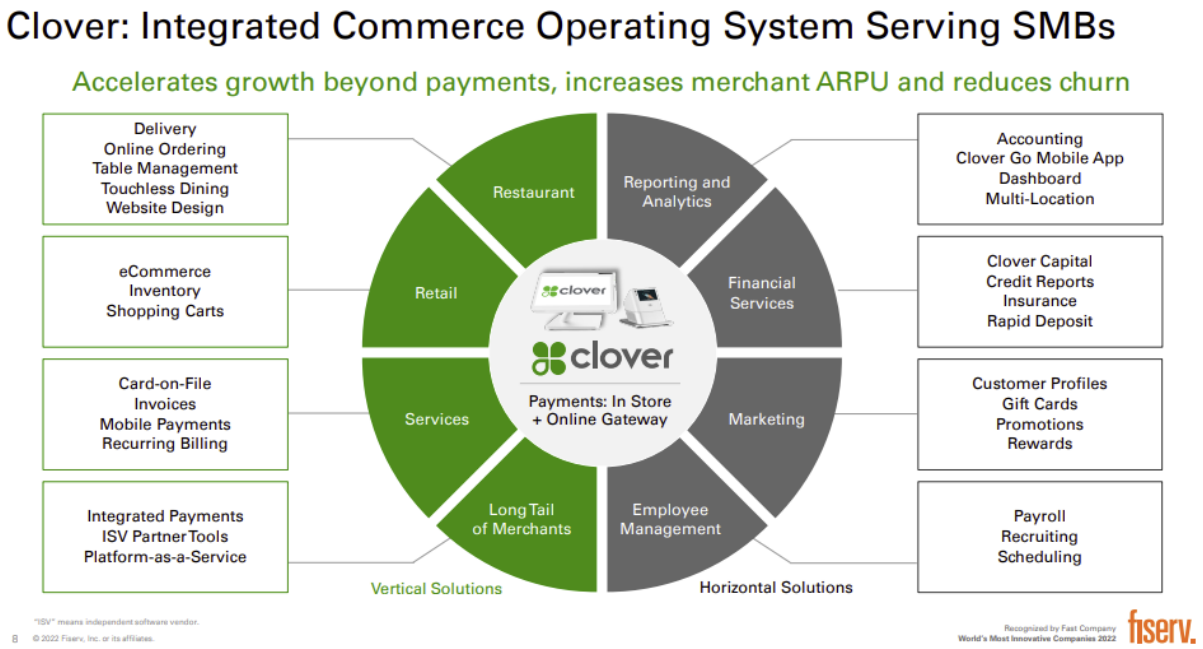
Most of the disruptors have attacked legacy players via software, which is more functional and adaptable than legacy systems, increases acceptance rates, and lowers costs. Disruptors have often targeted the needs of specific market segments. For example, Square has taken share in the Micro Merchant (<$125K volume) category by offering software tailored to distinct industries such as retail shops.

Fiserv has responded by introducing its innovative Clover and Carat products (discussed in detail below). These products have enabled Fiserv to shift from historically providing merchants with point solutions, to now offering fully integrated operating systems. With these newer products, Fiserv is well positioned to benefit from the shift of small and medium-sized business' (SMBs) preferences for fully integrated software payment systems, as well as their willingness to pay a higher Merchant Discount Rate (MDR) for these added services.

Pricing is attractive in the SMB segment, as it represents 30-35% of US bank card purchase volume but generates 65%-75% of domestic revenues. Larger merchants demand price concessions given the volumes they represent, but SMBs hold much less negotiating power with acquirers. This higher SMB spread increases even further as more value-added services are adopted by merchants.

Clover (SMBs)

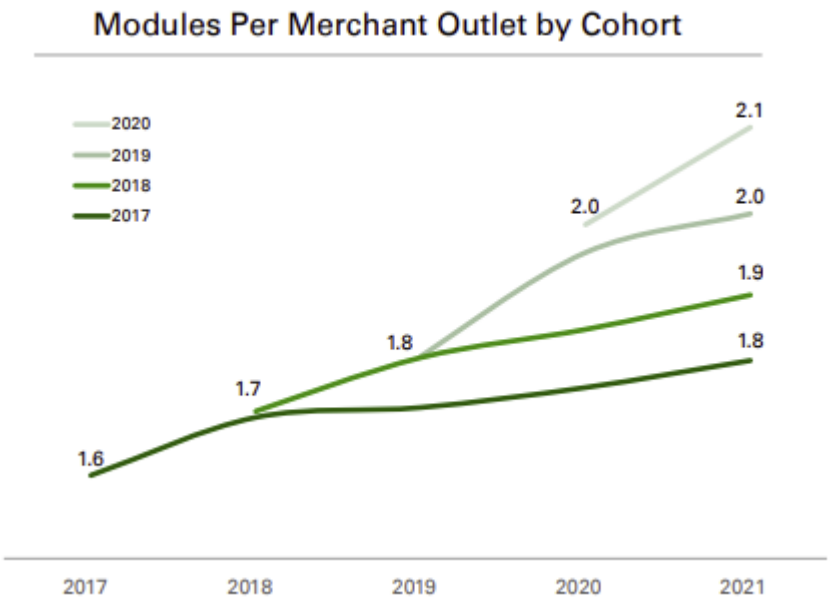
Fiserv acquired Clover through its acquisition of First Data and has since developed it into a powerhouse in the SMB acquiring market. Clover's value proposition is separated into cloud-based vertical solutions and horizontal solutions.



Clover's operating software is tailored to specific merchant verticals. Fiserv currently focuses on restaurants, retail, and service industries. Clover also targets what it calls "Long-Tail Merchants" that offer payment systems and tools from integrated software vendors (ISVs) through Clover's app store. Fiserv partners with software developers to offer merchants unique products allowing them to meet the changing demands of end consumers. Horizontal solutions allow merchants to operate and scale considerably more efficiently than previously available alternatives. For example, Clover offers integrated payment systems that allow merchants to receive payments in omnichannel methods, such as curbside pick-up.

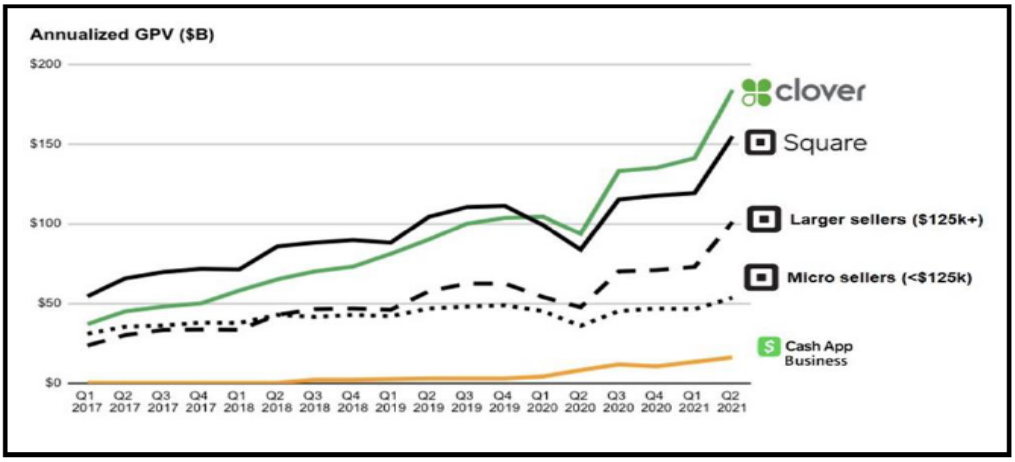
These vertical and horizontal solutions not only attract merchants to Fiserv, but the added features are very sticky services that increase switching costs. Once a merchant is acquired by Fiserv and begins running the entirety of its business on the platform, there are limited reasons why the client would switch at the time of contract renewal. Changing an integrated provider entails cost, business disruption risk, employee training, etc. These factors provide some pricing power to the company, especially in the SMB segment where businesses are less likely to have the in-house expertise to perform similar services. The increase in take rate is generally a cheaper alternative for SMBs compared to developing the software themselves or outsourcing a pure technology resource that does not integrate payments as well.

Clover has already shown remarkable success, generating $1.3B in recurring revenue and growing at a 27% CAGR. Modules by cohort have also been growing each year, which exemplifies the effective product bundling Clover has produced and its ability to upsell clients once integrated into their operating systems.



Source: Fiserv Company Reports.

Clover has been able to grow substantially faster than its peers in the SMB market on a Gross Payment Volume (GPV) basis (see chart and table below). Clover's growth over the years compared to Square demonstrates that the product is well accepted by merchants and that Fiserv is capable of taking on Fintech challengers.



Source: BlueToothDDS

Gross Payment Volume Growth (YoY)	2018				2019				2020				2021		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
clover	50%+	50%+	45%	45%	40%	40%	40%	40%	29%	4%	30%	25%	36%	96%	47%
Square	31%	30%	26%	26%	24%	22%	25%	24%	12%	-20%	5%	5%	21%	87%	43%

Source: Fiserv/Square

Square has been able to generate higher revenues as compared to Clover due to its higher take-rate (110bps vs. 80bps). However, as Clover continues to increase the number of modules per customer, Clover's take-rate will increase, allowing it to capture incremental revenue from clients. Software and services revenue currently sits at 12% of Clover revenue and management is targeting 20%+ by 2025.

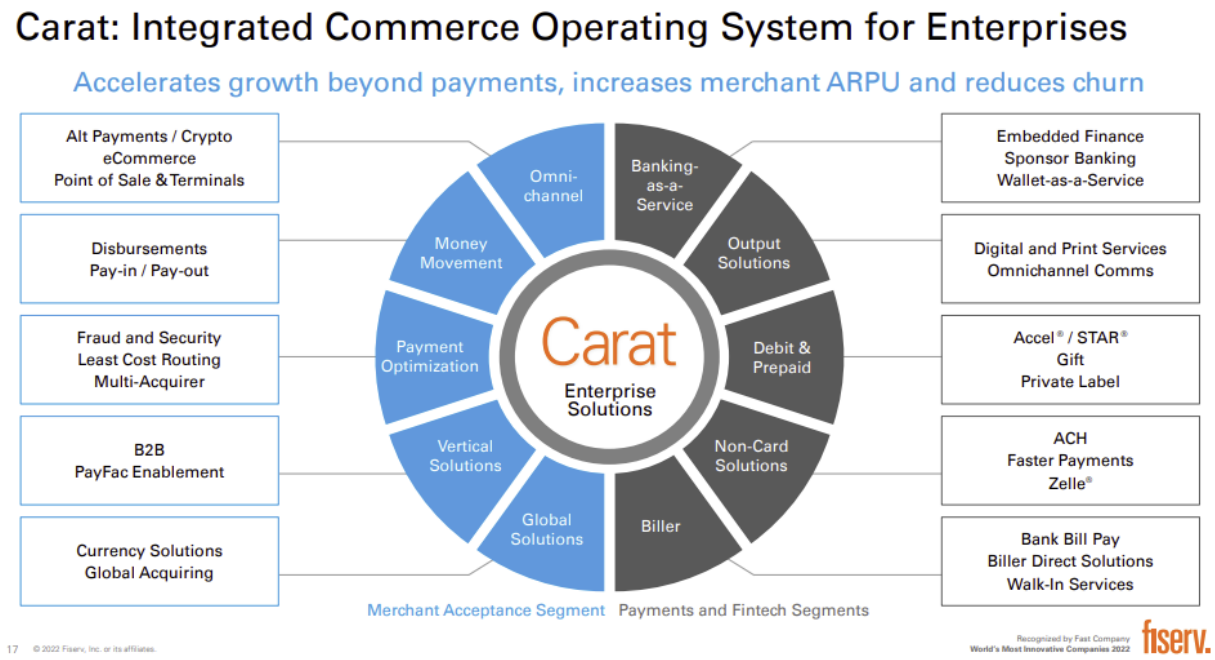
Fiserv has not yet begun switching its legacy book of merchants onto the Clover service as they are currently focusing their efforts and capital on acquiring new merchants. Per Fiserv's management: 90% of Clover's clients are new clients to Fiserv. We believe that Fiserv will gradually convert its legacy book onto Clover as renewals approach. Switching the back book to Clover should eventually translate into additional margin expansion via Clover's add-on services.

Finally, we note that Activist investor ValueAct Capital took a position in Fiserv in 2021 and recently secured board representation. ValueAct's bullish view on the value of Clover on a standalone basis is a major part of that firm's investment thesis.[1]

Carat (Enterprise):

The Carat platform is a leading-edge customizable software product, specifically designed as an operating system for large enterprises. Fiserv's global reach and partnerships with banks worldwide make Carat an attractive partner for large enterprise clients who require global capabilities

(1) https://www.bloomberg.com/news/articles/2022-02-23/valueact-gets-board-seat-at-fiserv-touts-potential-of-clover



Carat acts as a single-entry point allowing merchants to access the breadth of Fiserv's capabilities. As merchants become more efficient by utilizing these add-on solutions, Fiserv generates additional revenues at better economics.

The biggest apparent threat to Fiserv in the enterprise space is European disrupter Adyen, that acts as the sole intermediary between the merchant, card network, and consumer.

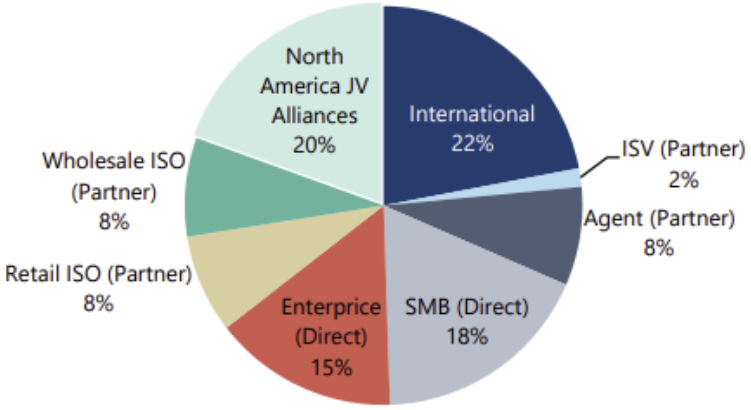
Adyen's offering has proven to be successful in the European market and the company has begun to take share in the enterprise space across North America. Adyen's enterprise customers value the data and higher authorization rates their solutions can provide and have shown they are willing to pay a higher take rate for these benefits. This is amplified in the eCommerce market, where close to 20% of online transactions are declined, compared to only 5% of offline payments.

The major risk posed to Fiserv by Adyen is that enterprise companies currently using Adyen internationally will switch to Adyen in North America (Fiserv's home market). Adyen's threat to Fiserv's North American clients will take time to unfold as merchants face switching costs from contractual agreements and would need to replace integrated software that affects their day-to-day operations. Fiserv is fighting back with its Carat enterprise offering and has shown that it is competitive in this segment, growing at a 12% CAGR since its introduction. We believe that the Carat product will continue to show success allowing Fiserv to maintain its market share and benefit from industry growth.

Further, Fiserv's enterprise segment only represents 17% of its Merchant acquiring business and 7% of the company's revenues. Even if Adyen manages to take a portion of Fiserv's enterprise merchants, it should not be materially detrimental to the business. As Adyen does not develop industry-specific verticals that Fiserv uses to attract its SMB merchants, we do not see Adyen as a large threat to Fiserv's largest, fastest-growing and most profitable segment.

Distribution Channels

Fiserv uses multiple distribution channels to capture the payment processing business of millions of merchants worldwide. This strategy provides the company with an advantage as it can cross sell its Clover and Carat products through its channel partners and grow in all areas of the market. We believe that Fiserv's shift to tech-enabled channels (ISVs, direct e-Commerce) will continue its growth trend, and become a much larger mix of acceptance revenues going forward. Additionally, Fiserv has shown its ability to grow its acquired business outside of the US through expansion into India, Argentina, and Brazil with international revenues growing at a 36% pace over the past two years.



Source: Jefferies Estimates, Company Data

Payments and Networks Segment

Fiserv generates 38% of revenue from its payments and networks segment in which it is the industry leader. Fiserv processes debit, credit, and prepaid cards for FIs and corporate clients. Through partnerships with banks, Fiserv processes ~35% of the volume across the top 10 US acquirers and has more than a 28% market share in the processing market. Payment processing is highly scalable, and Fiserv's dominant position gives it a clear cost advantage over smaller processors entering the market.

Acquirer	Bank Card Volume	Market Share	Processor
Chase Merchant Services	$ 1,460,821	27.60%	In-House
FIS (including Worldpay)	$ 1,269,965	25.10%	In-House
Fiserv	$ 906,350	17.9%	Fiserv
Wells Fargo	$ 709,547	14.0%	Fiserv*
Global Payments	$ 580,137	11.5%	In-House
BAMS	$ 452,124	8.9%	Fiserv*
Bank of America	$ 339,217	6.7%	In-House
Elavon	$ 277,938	5.5%	In-House
Citi Merchant Services	$ 190,472	3.8%	Fiserv
PNC Merchant Services	$ 66,043	1.3%	Fiserv
Truist Financial	$ 53,995	1.1%	Fiserv

*Wells Fargo ownership: 60% Wells Fargo, 40% Fiserv.
*BAMS was dissolved June 20, with 51% ownership going to Fiserv and 49% going to Bank of America.
Source: Nilson

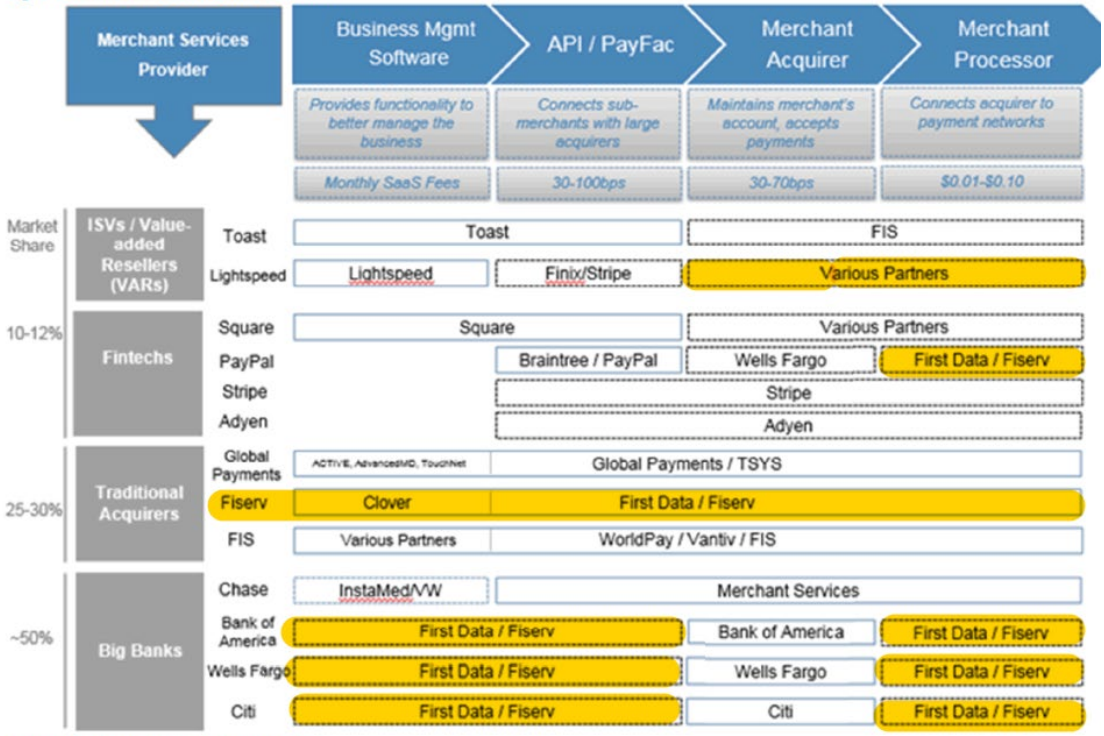
Industry volumes grow annually which in turn drives industry revenue growth. Volume growth is a function of personal consumption expenditure (PCE) which typically grows faster than Gross Domestic Product (GDP) and the secular shift away from cash. Card purchases have been growing at a 6% premium to PCE growth. The combination of these factors leads to high single-digit payment processing revenue growth.

Apart from traditional acquirers, Fiserv also operates the back-end processing for Fintech players like **Chime, Braintree**, and **PayPal** (PYPL). Fiserv owns two PIN debit networks (STAR and Accel) which combine to make it the number three US debit network after V/MA and generate $700m in revenue. Network volume is expected to grow as partners increasingly use Fiserv's rails for additional services like bill pay and contactless payments.

The move to peer-to-peer (P2P) payments has been gaining traction with apps such as CashApp (SQ) and Venmo (PYPL), recognized as the fastest growers in the payments segment. Less recognized is Zelle, which is operated by top US banks and enables customers to transfer money P2P directly from their bank accounts. Zelle is similar to Interac e-Transfer in our home market of Canada. Zelle already processes two times Venmo's volume and banks have an incentive to heavily promote Zelle to keep customers' deposits in-house. Most consumers still feel more comfortable using traditional banks for money transfers evidenced by ~60% of people immediately transferring funds received in a P2P app into their bank account. Fiserv provides back-end processing and other turn-key solutions for Zelle's transactions, therefore benefiting directly from the scale and transaction volume that Zelle gains in the industry.

The following table demonstrates that Fiserv's broad offerings position the company to compete in most segments of the merchant services value chain.

Figure 13: Merchant Services Value Chain



Source: Company reports and J.P. Morgan estimates.

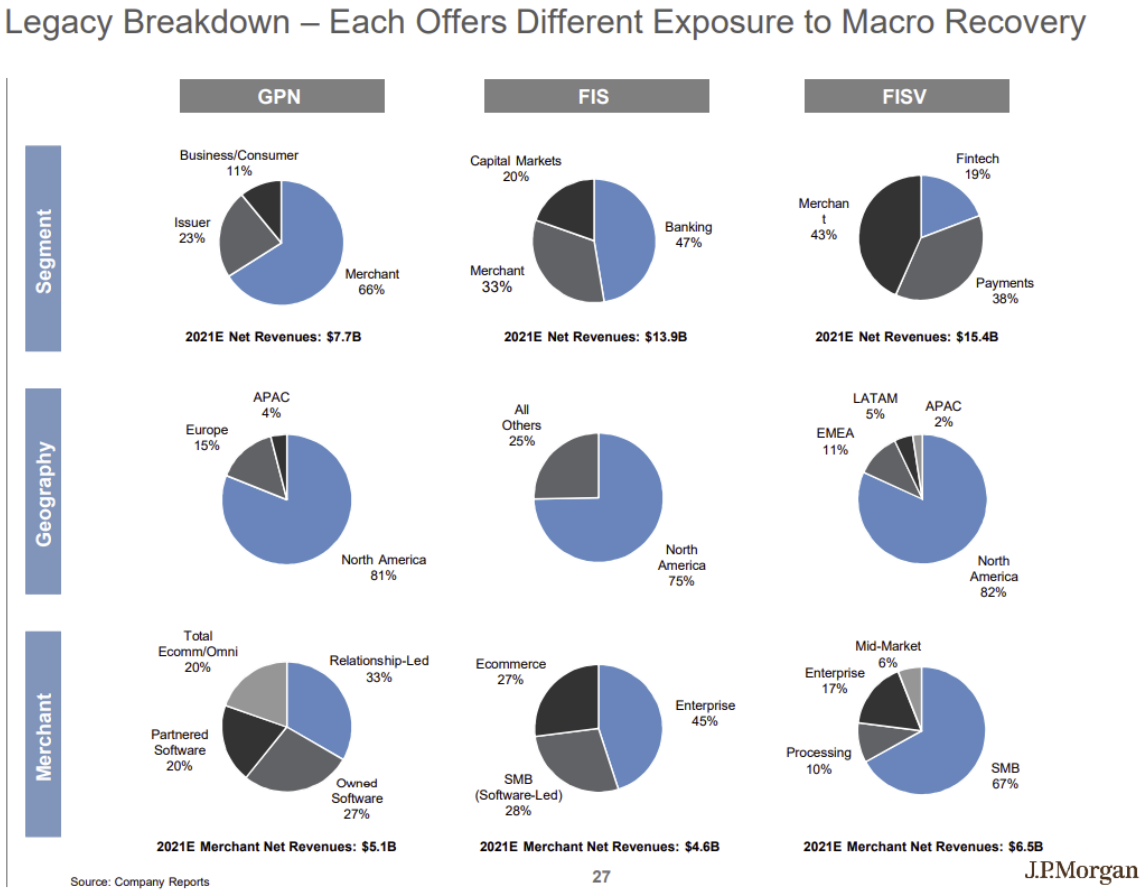
Fintech Segment

Fiserv's fintech segment lies in core bank offerings, which act as the "plumbing" for banks and enable them to maintain their deposit and loan accounts, as well as post daily transactions. Fiserv offers services to 4,600 banks across the world. This segment is likely the stickiest as it is very time-consuming and expensive for banks to switch their systems which introduces the risk of disrupting their ability to serve customers. Growth in this segment is also expected to be mid-single digits as banks continue to upgrade old operating systems to products such as Fiserv. Additionally, the trend towards outsourcing core systems has grown, with 95% of new bank cores and 70% of new credit union cores being deployed in a hosted environment.

Apart from the stable revenues that this segment provides to Fiserv, the entrenched relationship with 40% of US banks and credit unions provides a unique opportunity to cross-sell acceptance and processing products to these FIs and their customers.

Competitive Positioning

The Legacy players in the payment industry (FIS, FISV, GPN) generally possess sufficient scale and product offerings but have historically differentiated themselves by targeting different business segments and geographies.



In our analysis, we view FISV as being the best-positioned legacy player. GPN's relatively large merchant segment makes it the most susceptible to cyclical pressures during economic downturns. FIS's high enterprise merchant revenues makes Adyen a greater threat to their business mix. Of the three major players, we found Fiserv's revenue mix across segments, geographies, and merchant types appealing. Fiserv also has the greatest scale amongst the three legacy players. Combining this with Fiserv's distribution strengths, we believe they will be able to maintain a dominant position amongst legacy players and reap the benefits of industry growth going forward.

Valuation

Fiserv's projected growth by segment is detailed in the table below with merchant acceptance being a key driver for the company. The assumptions provided by the company are based on their current assets and do not factor in any M&A contributing to growth.

Fiserv Inc.	2020				2021				2022	Long-Term
NASDAQ: FISV	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Growth Forecast
Merchant Accepetance Revenue	$1,335	$1,167	$1,456	$1,444	$1,397	$1,666	$1,716	$1,700	$1,653	9%-12%
Operating Margin	21.20%	19.10%	29.20%	30.70%	27.70%	31.50%	32.20%	31.40%	28.40%	
Payment Processing Revenue	$1,396	$1,329	$1,396	$1,423	$1,412	$1,427	$1,479	$1,542	$1,469	5%-7%
Operating Margin	41.20%	42.00%	43.60%	46.40%	41.40%	44.60%	43.90%	45.80%	42.50%	
Financial Technology Revenue	$718	$714	$727	$742	$736	$754	$761	$771	$778	4%-6%
Operating Margin	28.40%	35.30%	35.50%	36.50%	33.40%	36.20%	36.10%	37.20%	35.40%	
Consolidated Revenue	$3,478	$3,220	$3,590	$3,620	$3,557	$3,855	$3,962	$4,019	$3,906	7%-9%
Operating Margin	27.80%	28.80%	32.90%	35.60%	31.40%	34.00%	34.20%	35.60%	32.05%	
Adjusted EPS	$0.99	$0.93	$1.20	$1.30	$1.17	$1.37	$1.47	$1.57	$1.40	15%-20%

Source: Company Reports, GreensKeeper.

The company's growth algorithm is attractive. Consolidated revenue growth of 7-9% + an estimated 500bps of operating margin expansion (driven by scale and an increased acceptance take-rate) + share buybacks = EPS compounding at 15-20% in the medium-term. Having delevered post the First Data merger, Fiserv is now at its target leverage ratio of 3.0x debt/Adj. EBITDA. As a result, the company's abundant free cash flow will be put to work opportunistically via M&A and/or accelerated share repurchases. We view the current management team's capital allocation favourably given their track record of execution.

Using a conservative discount rate of 10% and a 20X FCF multiple on our 2023 estimated FCF of $7.05 per share, we believe that the company has an intrinsic value of approximately $142. We project an 19% IRR with the shares currently trading at $100.13. For reference, the company has consistently traded between 21x and 26x FCF since 2014. If Fiserv meets its growth targets (which we view as credible), these are reasonable assumptions for a company that has a market-leading position, attractive margins and high ROIC (~ 56%).

Risks

Innovation

Processors are exposed to the risk of losing clients if they are not capable of innovating to meet client demands. This happened in 2020 when JP Morgan announced that Marqeta would be the processor for its digital-only cards, as its legacy provider was unable to allow mobile wallets without a significant-tech build. If Fiserv is unable to continue to improve its offerings to clients through internal R&D and strategic M&A, they risk losing market share to competition with a superior offering.

Contracts

Fiserv enters into multi-year contracts with clients. Many large clients will often use one processor for most of their business while maintaining relationships with other processors using a smaller portion of their payments. This gives clients more negotiating power when contracts come up for renewal, which can lower margins for processors. Additionally, the general bank consolidation trend gives them more negotiating power on core processing accounts due to their increased size. Fiserv is exposed to this risk as they operate in partnership with many mid-sized banks that are prime targets for mergers and acquisitions. Losing volume to a competitor can result in operating deleverage.

End-to-end players

Companies with two-sided networks in which both the customers and merchants are the “customer”, can offer differentiated experiences to both parties. For example, JP Morgan’s Chase bank (Chase) has a large merchant acquirer share and a large consumer card share across the US. Chase can use this two-sided effect to offer merchants lower processing fees on transactions made using the Chase card. The direct consumer relationship also allows Chase to achieve higher authorization rates on payments made through its cards given the data it has on the consumer. Another example is PayPal, which incentivizes users to make payments using the PayPal checkout button by offering an extra 1% cashback on the PayPal credit card. Both of these scenarios are potential threats to Fiserv’s payment volumes.

General

Fiserv is subject to a wide variety of risks including changing regulation, litigation, fraud, cybersecurity, and economic and geopolitical factors. Please review the company’s latest 10K and other public filings for additional risk factors. Conduct your own research before making investment decisions.

Conclusion

Despite the payment industry being riddled with emerging competitive threats, we believe Fiserv’s dominant position will remain. While we acknowledge the risk of new entrants in the merchant acquiring space, Clover and Carat are both world-class products that deliver value to merchants globally. Combined with Fiserv’s unmatched processing scale, Fiserv should continue to grow and thrive.

At the current price of $100.13 the stock trades at a forward P/E of 15x we view Fiserv as an attractive investment opportunity with a target price of $142 and an IRR of 19%.

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