Q4 2017 Earnings Call

Company Participants

- Gabrielle Scheibe Rabinovitch
- Daniel H. Schulman
- John D. Rainey
- William J. Ready

Other Participants

- Heath Terry
- Bryan C. Keane
- Tien-Tsin Huang
- Sanjay Sakhrani
- James E. Faucette
- Paul Condra
- Ashwin Shirvaikar
- Darrin Peller

MANAGEMENT DISCUSSION SECTION

Gabrielle Scheibe Rabinovitch

GAAP and Non-GAAP Financial Measures

We will discuss some non-GAAP measures in talking about our company's performance

You can find a reconciliation of these non-GAAP measures to the most directly comparable GAAP measures in the presentation accompanying this conference call

Daniel H. Schulman

Business Highlights

Core Platform

- 2017 was a transformative year for PayPal with consistently strong and, in many cases, record-breaking results
- I'd like to highlight a couple of areas, in particular
- First, we achieved record net new actives and engagement on our core platform by increasing our reach and relevance with both consumers and merchants
- Importantly, we anticipate this elevated level of net new actives to continue in 2018 as we experience increasing network effects from our scale

Market Share

- Second, we continue to grow our market share through our increasing leadership in mobile and by introducing a suite of new and innovative services and product experiences for our customers

Customer Choice

- Third, we meaningfully strengthened our competitive positioning through the rollout of Customer Choice
- The combination of Customer Choice and our move towards an open platform architecture enabled strategic partnerships with many of the world's leading companies
- Several of these companies had previously been perceived as potential adversaries
  - These partnerships have opened new avenues of growth from geographic expansion to in-store payments

New Long-Term Strategic Partnership with Synchrony Financial

- Fourth, we announced a new long-term strategic partnership with Synchrony Financial, which will result in PayPal receiving more than $6B in cash proceeds at closing
- The deal also frees up more than $1B in FCF each year, which we will allocate to higher-yielding organic and inorganic growth opportunities
- Finally, we did all this while delivering consistently strong financial results

Volume and Revenue

- I'll discuss the first four areas in more detail in a moment, but I want to start with our financial results for Q4
- I'm pleased to say that Q4 was our strongest quarter of the year, capping off a landmark to 2017
- Payment volume grew 29% on a currency-neutral basis to $131.4B, generating revenue of $3.71B
- Revenue grew by 24%, and this is our third consecutive quarter of accelerating revenue growth
- The strong revenue performance, combined with disciplined OpEx management, drove non-GAAP EPS of $0.55, which was up 30% y-over-y

Customer Metrics

- Our customer metrics were particularly strong
- We drove a record 8.7mm net new active accounts, and that was up 61% over Q4 of 2016
- And we ended the year with 227mm active accounts, adding more than 29mm net new actives for the year
- And it's worth noting that we now serve 18mm merchants on our platform
- Importantly, engagement was once again higher at 33.6 transactions per active account

Net New Active Growth

- And I think it's instructive to note that our accelerating net new active growth hides the true underlying growth of engagement

- If our total net new adds had grown at the same rate as last year, our growth in engagement would have increased 11% to approximately 34.5
- It's particularly encouraging that our net new active cohorts acquired in 2017 are showing an acceleration in engagement vs. similar cohorts from 2016
- The net takeaway is we are bringing on record net new actives with higher engagement than ever before, and that obviously bodes well as we look ahead

Partnership with Synchrony Financial

- Our partnership with Synchrony Financial accomplishes every goal we set out for our asset-light strategy
- The transaction substantially reduces our overall risk profile
- It provides us the opportunity to double down on our innovative credit experiences for our merchants and our consumers while sharing in the profit growth

Cash Flow

- And as I said earlier, it frees up approximately $1B in annualized cash flows and more than $6B in cash
- If we combine this cash windfall with the ability to repatriate these funds due to the recently passed tax reform bill, we dramatically increase the flexibility of our cash position, enabling us to more efficiently allocate our capital to higher-yielding opportunities
- John will be sharing more details later in the call about the strategic benefits of our Synchrony partnership and will discuss the impact of the Synchrony transaction on our Q4 results and our expectations for 2018

Digital Payments

- This past year saw strength in our leadership position in digital payments, and we substantially expanded our opportunities for future growth
- We introduced a host of new product experiences, and they're driving further differentiation from our competitors
- Customer Choice is central to this effort and continues to be an important element in the evolution of PayPal

International Performance

- In Q4, we completed the rollout of Choice in the United States, the UK, Australia, Canada and Japan, with 30mm consumers now opted in
- In the United States where Choice has been live to site for more than 12 months, we continue to see a meaningful lift in engagement and payment volume and a significant reduction in churn
- And consistent with previous quarters, our transaction expenses remain well within our expectations as evidenced by our increasing OI margins

Volume

- Across the globe, contact rates into our customer service centers continue to decline

- In fact, in Q4 this year, we experienced lower overall call volumes into our customer service centers than we did in Q4 2014, despite our base increasing by 65mm active accounts and literarily billions of additional transactions
- I attribute our reduction in call volume to not only Choice, but to the tremendous strides Bill and his team have made in enhancing our core experiences from improved availability to decreased latency, to increased feature functionality and reduced friction across our platform

PayPal Platform

- This quarter was particularly significant in a number of new and notable large merchants who joined the PayPal platform
- Merchants are increasingly choosing PayPal for our ability to deliver the tools they need to compete and thrive in an increasingly competitive global and mobile environment
- If you combine that with a value of the 209mm engaged consumers we bring to their omni-channels, you can see why we have such a strong and compelling value proposition for merchants
  - This quarter, we signed a global agreement with The Walt Disney Company

QVC

- We welcomed Dillard's, which ranks among the nation's largest fashion retailers
- QVC has agreed to make PayPal available to their customers
- And the QVC Group is the number three in e-commerce in North America and number three in mobile commerce in the U.S. according to Internet Retailer

Europe

- In Europe, ePRICE, which is the largest Italian marketplace, began accepting PayPal payments; and Dell began offering PayPal Credit in the UK.
- In India, PayPal is available as a way to pay on BookMyShow and MakeMyTrip, the largest online entertainment ticketing platform and the largest online travel company in the country
- This holiday season clearly demonstrated the powerful trends that are reshaping retail and driving new consumer behaviors, driven by the increasing penetration of smartphones
  - These trends drove strong mobile engagement on our platform over the busy holiday shopping season
- PayPal processed $48B in mobile payment volume in Q4, and that was a 53% growth y-over-y and 36% of our quarterly TPV
- For the full year, mobile represented 34% of overall payment volume on our platform, with total mobile payment volume growing 52% to $155B for the year

One Touch

- Our leadership in mobile continues to be driven by the exceptional experiences we're able to deliver
- We continue to drive fast, frictionless and engaging consumer experiences with our One Touch products

- We ended Q4 with over 80mm consumers opted into One Touch, up from 40mm a year ago, and the number of merchants offering One Touch now totals more than 8mm compared with 5mm a year ago

Venmo

- Venmo continues to define digital payments for a generation of passionate users here in the U.S
- For the first time in the quarter, Venmo surpassed $10B in payment volume, with $10.4B processed in Q4, an increase of 86% y-over-y
- For the full year, Venmo's volume increased 97%, with almost $35B in payment volume processed
  - We also experienced another very strong quarter of net new adds to Venmo and added the largest cohort of annual net new actives to Venmo in its history
- We continued over rollout of Pay with Venmo, providing our Venmo users with more ways to pay with the service they love and giving our merchants access to this coveted demographic

Tailwind

- While we are still in the early stages of monetization, we are very encouraged by our initial leads on engagement
- In fact, the adoption of services that we are able to monetize on Venmo is tracking above the P2P adoption Venmo experienced at a similar point in its history
- Given our experience this past year, we believe our future opportunities are expansive and compelling
  - We're riding powerful and accelerating tailwinds, created by two global trends: the digitization of cash and the mass adoption of mobile devices
- We are actively positioning ourselves to take the full advantage of these trends and strategically moving our business into areas where we believe these transformations are creating the strongest opportunities

Digital Mobile Transformation

- Throughout 2017, we redefined our competitive position in our ecosystem, entering into strategic partnerships with many of the companies leading the digital mobile transformation around the world
- We are now in the process of implementing productive and expansive partnerships with Visa, Mastercard, Discover, Bank of America and China UnionPay
- We are working closely with over 20 of the largest credit card issuers in the world, the majority of which have kicked off campaigns to encourage and, in many cases, incent customers to engage with PayPal

Citi and FIS

- For example, we are working with both Citi and FIS to create experiences that are driving enhanced consumer engagement and activation
- With Citi, customers can provision their Citi cards to new or existing PayPal accounts directly from Citi's online properties
- With FIS, the ability to link accounts directly to PayPal is now available to all of FIS' banking customers

Agreement with Bank of America

- We signed an agreement with Bank of America to enable PayPal as a way to disperse payments on behalf of their corporate clients
- And this year, we will integrate credit card reward points from major issuers into our PayPal Wallet as a funding source for consumers to use when they purchase at PayPal merchants, and we will also begin to roll out the use of industry-standard tokens to pay in-store wherever NFC is accepted

Partnership with Facebook Messenger

- In the quarter, we expanded our partnership with Facebook Messenger adding contextual commerce experience that allows sellers to send invoices to buyers as well as adding PayPal as a way to fund P2P transactions within Messenger conversations
- In China where mobile payments are a thriving part of everyday life, our relationships with strategic partners have the potential to substantially increase our opportunity
- PayPal is now used by tens of thousands of Chinese merchants on the AliExpress website in order to transact seamlessly with PayPal consumers outside of China
  - We are also eagerly looking forward to the upcoming launch of our Baidu partnership

Domestic Operations

- In November, we announced the launch of our domestic operations in India, opening another substantial market for PayPal
- While we have been supporting India merchants for years by helping them sell to international buyers, we are now able to work with key merchants to sell domestically as well
  - We plan to aggressively expand this program to more merchants in India throughout 2018
- India is a market in which the government is actively working towards demonetization and building a modern, digital economy, and we view India as a strong and compelling opportunity for PayPal
- With well more than a billion digital consumers and a thriving online merchant community, deepening our engagement in China and India will continue to be a priority for PayPal in 2018, and we believe these markets offer significant opportunities to drive substantial scale

Relationship with eBay

- I'd also like to comment on our relationship with eBay
- We have a very close partnership and a long history with eBay
- This is governed by an operating agreement that runs for another two-and-a-half years through July 2020
- The operating agreement lays out a thoughtful transition and allows for a smooth migration from jointly-owned entities to independent companies for the five years following separation
- The agreement allows for eBay to eventually become Merchant of Record and play a more direct role in managing the payment experience on their platform, and we are actively partnering with eBay to help their implementation of Merchant of Record capabilities

Operating Agreement

- The operating agreement also allows for eBay to work with alternate payment service providers over time, as they transition to Merchant of Record
- As part of that, I'm very pleased to announce that PayPal and eBay have signed a term sheet to provide our branded services at least through July 2023
- Both our 2018 and our medium-term guidance already include the anticipated economic impact of the eBay transition, which is quite manageable over a multiyear period

Medium-Term Guidance

- As such, we see no need to change our medium-term guidance
- Given our long history with eBay buyers and sellers, both Devin Wenig and I believe a manageable transition and sustained relationship is in the best interest of our mutual customers
- I'm very pleased we have agreed to extend our partnership and look forward to building on the strong relationship we've established since separation

Accomplishments

- As I said at the beginning of my remarks, 2017 was a landmark year for PayPal on multiple fronts
- We entered 2018 with strong and accelerating trends, supporting our increasingly differentiated and expansive value proposition and scale
- We have extended our branded PayPal relationship with eBay through July 2023, which was one of our primary goals in 2017
  - These accomplishments set us up for sustainable and predictable growth over the foreseeable future
- We fully understand the need to work even harder to live up to and deliver on the value our customers and shareholders expect from us
- We have a substantial opportunity to shape the future of digital payments over the next decade, and we are looking forward to another strong year in 2018

John D. Rainey

Financial Highlights

Volume and Revenue

- I also want to thank all of PayPal's customers, partners and employees for making 2017 a great year
- We achieved many significant milestones in 2017 and are well positioned to continue delivering on our commitments and executing against our strategic plans
- Before I go to details on Q4, I'd like to provide a few highlights for the full year
- For 2017, active accounts grew 15% to 227mm, an acceleration of 500BPS over the 2016 growth rate
- Payment volume grew 27% on a currency-neutral basis to $451B

- Approximately 34% of this volume was mobile where we saw 52% volume growth for the year
- Revenue for 2017 exceeded $13B, growing 21% on a currency-neutral basis

Non-GAAP EPS

- For the full year, revenue related to eBay Marketplaces grew 7%, while our Merchant Services revenue grew 24%, more than 3 times the rate of our legacy eBay Marketplaces business
- For the year, non-GAAP EPS grew 27% to $1.90, and we returned more than $1B to shareholders

Tax Reform

- I'd first like to discuss the impact of tax reform
- We believe the modernization of the U.S. tax code is a significant step forward and a clear positive for PayPal and its shareholders
- The ability to more efficiently and strategically allocate capital is an unmitigated benefit, the full value of which we expect to realize over the medium and long term
- I would note that there's still a number of open items that require clarification, and we may refine our estimated impact in future quarters, as further information and interpretations become available

Deferred Tax Assets and Liabilities

- Our fourth quarter GAAP results include a one-time charge of $180mm related to the deemed repatriation of unremitted earnings on foreign subsidiaries and the revaluation of deferred tax assets and liabilities
- We expect our non-GAAP effective tax rate to be in the range of 17% to 20% over the next three years
  - We will tighten this range as we get more clarity
- I'd now like to review the items included in non-GAAP results from the reclassification of our U.S. consumer credit receivables portfolio to held-for-sale relating to our November agreement with Synchrony Financial
- These changes reduce comparability to prior periods

U.S. Consumer Credit Portfolio

- Where relevant to the discussion, I'll provide normalized results to adjust for these changes
- Following the closing of the transaction, which we expect to occur in Q3, the U.S. consumer credit portfolio will no longer sit on our balance sheet and we will no longer incur any costs related to the charge-off of principal or interest
  - First, other value-added services revenue benefited by approximately $26mm in the quarter as a result of no longer recognizing reserves on interest receivables for the U.S. consumer credit portfolio
  - Second, transaction and loan losses benefited by approximately $74mm from no longer recognizing reserves on principal receivables for the U.S. consumer credit portfolio
  - And third, non-transaction-related expenses were negatively impacted by $92mm from the recognition of incurred charge-offs of principal and interest

- There's also a GAAP earnings impact from the transaction, consistent with our prior disclosures related to the agreement, and those are noted in the Investor Update posted today

Q4 Results

Volume

- Moving to our results, for Q4, our total payment volume was $131B, up 32% on a spot basis and 29% on a currency-neutral basis
- Merchant Services volume grew 33% on a currency-neutral basis to $114B, representing 87% of our volume in the quarter
- Volume associated with eBay represented 13% of the total compared to 16% for Q4 2016 and 19% two years ago

Merchant Services

- P2P volume, which is a component of Merchant Services and includes volumes across core, Venmo and Xoom, grew 50% to $27B and represented approximately 20% of total payment volume
- During Q4, growth in active accounts was 15%
- We ended the quarter with 227mm customer accounts
- We added 8.7mm active accounts in the quarter
  - This marks the fourth consecutive quarter where we have experienced an acceleration in the growth of active accounts
- And in each of the last five quarters, we have added a record number of net new customer accounts
- Account growth in the quarter was primarily driven by our core PayPal business, followed by strong growth in Venmo accounts

Transaction Revenue

- Revenue grew 24% on a spot basis in Q4 with 23% growth in transaction revenue and 32% growth in other value-added services
- Transaction revenue growth was primarily driven by our core PayPal and Braintree businesses
- Normalizing for the effect of held-for-sale accounting, revenue growth from other value-added services was driven by strong credit growth on the consumer side as well as the acquisition of Swift Financial

Transaction Take Rate

- Both total and transaction take rates are affected by our hedging program, as we recognize hedge gains and losses in international transaction revenue
- In Q4, we incurred a hedging loss of $29mm compared to $50mm gain in Q4 of 2016, resulting in $79mm headwind in the period
- For Q4, our transaction take rate was 2.45%, a decline of 18BPS from Q4 2016, and our total take rate was 2.82%, also down 18BPS y-over-y

- Growth in our P2P businesses, led by Venmo and the impact from the hedging loss, resulted in approximately two-thirds of the take rate decline, with the remaining 5 basis point decline resulting from the business mix effect of lower eBay growth in conjunction with strong Braintree growth

Volume-Based Expenses

- Volume-based expenses grew 26% in Q4
- Normalizing for the effect of held-for-sale accounting, these expenses would have grown in line with volume growth
- Transaction expense was $1.3B and represented 96BPS of TPV, consistent with the expense rate in Q4 2016 and our expectation that we would see less pressure in the back half of 2017 relative to H1
- Increased core take-off funding expenses were offset by lower funding costs from growth in P2P

Consumer Credit Portfolio

- Transaction loss in the quarter was $248mm or 19BPS of TPV, flat to the same period last year as well as Q3 2017
- Loan losses were $75mm, down nearly 40% from Q4 2016 as a result of the effect of held-for-sale accounting on our income statement
  - We estimate that this change in accounting designation benefited loan losses by approximately $74mm
- Due to the change to held-for-sale accounting, we no long are maintaining a reserve for losses and are reflecting in current losses in the line item called restructuring and other charges on our income statement as part of our non-transaction-related expenses
- Our consumer credit portfolio continues to perform in line with our expectations

Transaction Margin

- Transaction margin in dollars was $2.1B, growing 23%
- Adjusted for the impact of held-for-sale accounting, transaction margin was $2B, representing 17% growth vs. last year
  - This represents the highest rate of growth since separation
- For the quarter, transaction margin as a rate was 57.1%
- On an adjusted basis, transaction margin was 54.8%

Non-Transaction-Related Expenses

- Non-transaction-related expenses or other operating expenses grew 19% in the quarter
- Normalizing for the held-for-sale accounting adjustments, these non-transaction-related expenses would have grown approximately 10.5%, resulting in 385BPS of operating leverage
- Further adjusting for the acquisitions of Swift Financial and TIO Networks, we would have seen non-transaction-related expenses grow at approximately 6% for the quarter

- Relative to Q4 2016, in Q4 this year, sales and marketing expenses grew 25%, product development cost increased 10%, and customer support and operations cost grew 7%, consistent with the cadence of discretionary spending that we have previously discussed

Acquisitions of Swift Financial and TIO

- In the quarter, there were incremental costs related to our acquisitions of Swift Financial and TIO, which affected the growth of both sales and marketing and customer support costs
- In addition, we launched marketing campaigns for our P2P businesses in support of the global launch of our Choice initiative
- And in product development, we invested in our India domestic payments business, pay with Venmo, and in improving our core merchant and consumer experiences
- After adjusting for held-for-sale accounting treatment, non-transaction-related expenses increased $0.17 in Q4 for every incremental dollar of revenue
- After backing out incremental revenue and cost associated with our acquisitions of Swift Financial and TIO, these expenses increased only $0.11 for every incremental dollar of revenue
- And for the full year, these expenses increased only $0.10 for every dollar increase in revenue, indicative of the underlying leverage and scalability inherent in our operating model

Operating Income, Non-GAAP EPS and CapEx

- In Q4, operating income grew 30% to $807mm on 24% top line growth, resulting in 100BPS of operating leverage
- Non-GAAP EPS grew 30% in Q4 to $0.55
- Q4 CapExs were $108mm or approximately 5% of revenue
- As a result of changes from the designation of our U.S. consumer credit receivables portfolio, net new loans of $1.3B reduced cash flow from operations in the quarter
- Prior to this change in designation, this amount would have been recognized in cash flows for investing activities
- As a result, cash flow from operations in Q4 was negative $147mm, with FCF in the quarter of negative $327mm
- On a normalized basis, we would have recognized approximately $972mm in FCF, generating approximately $0.26 FCF for every dollar of revenue

Cash, Cash Equivalents and Investments

- We ended the quarter with cash, cash equivalents and investments of $7.7B
- In 2017, we returned $1B to shareholders in the form of stock repurchases, buying back our stock at an average price of $51
- Our business generates significant FCF
- In addition, tax reform in conjunction with the expected proceeds from the Synchrony transaction, and its implications for our go forward cash requirements positions PayPal with meaningful liquidity, flexibility and optionality as it relates to capital allocation decisions

- We expect to continue to deploy disciplined and balanced approach to capital allocation to preserve this flexibility and make strategic investments to deliver durable increases in shareholder value and long-term growth

Cash Repatriation Plan

- In 2018, we plan to continue investing organically, pursue acquisitions and partnerships, and increase our level of stock repurchases
- We are currently executing on tax planning strategies to serve our long-term business objectives
- The consequences of these strategies, in conjunction with regional regulatory and liquidity requirements, may affect our cash repatriation plans
    - We continue to move toward a more optimal capital structure to support capital allocation decisions and maximize value

Credit Facility

- In Q4, we announced a new $3B unsecured credit facility, and drew down $1B at the end of December
- I would now like to discuss our guidance for Q1 2018 and the full year
- For the full year 2018, we expect revenue between $15B and $15.25B, representing currency-neutral growth of 14% to 16%
    - This is in line with the guidance update we provided in mid-January, and incorporates the expected impact of approximately 3.5 points from the sale of our U.S. consumer receivables
- Our guidance contemplates modest expansion in our non-GAAP operating margin in 2018, and we anticipate our non-GAAP effective tax rate to be between 17% and 20%
- And we expect non-GAAP EPS of $2.24 to $2.30

FCF

- For 2018, we anticipate FCF to exceed $4.5B
- This is higher than normal due to the sale of our credit receivables next year, the proceeds of which will be split between operating and investing activities on the cash flow statement
- For Q1, we expect revenue in the range of $3.58B to $3.63B or 20% to 21% growth on a currency-neutral basis
    - We also expect non-GAAP EPS of $0.52 to $0.54

Cost Structure

- In closing, we are pleased with 2017 and the progress we've made across many fronts
- We focused our efforts on building great experiences for our customers, which led to a record consumer and merchant adds to our platform, and an acceleration of revenue and earnings growth
- We demonstrated sustainable improvements to our cost structure and significantly de-risked our business with the U.S. consumer credit transaction with Synchrony
    - We look forward to the opportunities we have in 2018 to continue this progress and further increase shareholder value

QUESTION AND ANSWER SECTION

<Q - Heath Terry>: Dan, John, there seems to be a bit of a disconnect between the way that eBay is presenting the new partnership or extension vs. the way that it's coming across on this call in the press release, primarily the difference being the Adyen partnership that eBay is talking about as being their primary partner now, and that they intend to transition the majority of their marketplace customers to this new payment experience that Adyen is powering. Can you help clarify for us a little bit of how – basically try and connect the dots between those two, and well, I know you've talked about there not being any sort of meaningful financial impact here as we get to the end of the original 2020 date. How does that change?

<A - Daniel H. Schulman>: Yes. Thanks for the question, Heath. So I'd start off with just saying that the eBay and PayPal has had a close relationship and a long history together. And I'm really pleased that we're extending that partnership on the branded side through July 2023. As I think most people on the call know, there's a 5-year operating agreement that governs our separation, and we're halfway through that. We got another 2.5 years left until the end of July 2020. And with this announcement here, there are no changes to any of the terms. And the operating agreement was meant to assure both a thoughtful and a smooth transition for both companies post separation. And it assumed in the operating agreement, as have we, that eBay will gradually transition to become an MOR.

And consequently all of our numbers, all of our plans have always included that assumption. So as we've given our medium-term guidance, that's been part of our assumption. And as a result, this announcement does not change our medium-term guidance or the way that we think about our long-term outlook. And let me give you some facts around that, because we strongly believe that the eBay transition to MOR is quite manageable for us. So why do we think that? So today, eBay, as John mentioned, is about 13% of our TPV, our total process volume, transaction process volume, and that's down about 900BPS in the last two-and-a-half years. So let's just assume that exactly the same thing happens over the next two-and-a-half years, and that we have no acquisitions or stuff, which, by the way, as you know, we are acquisitive, we're aggressive on that, we have a large cash balance that's coming to us.

So we can talk about acquisitions. That will be a part of our strategy going forward. But assuming no acquisition, eBay becomes approximately, at the end of the operating agreement, about 4% of our TPV. That's assuming, again, the same amount, the first two-and-a-half years to the second two-and-a-half years, and maybe less than 10% of our revenues. If eBay follows the example, and we actually have the great insight because we actually see what happens to marketplaces as they go to MOR because we worked with a number of marketplaces. And where marketplaces go to MOR, it typically takes them several years before the majority of their customers moved to MOR. And we've seen this and we've experienced, and post-MOR, we still retain about a 50% share of checkout. And so it takes several years post the end of the OA for the majority of customers to move. That's what our experience has been in the real market. And post that, we retain about 50% share of checkout.

So we think that this is going to be a very manageable transition over multiple years post the end of the OA. And I'll give you two more thoughts on this, and it's very important; one, we renewed the branded relationship with eBay because it is far and away the most profitable element of the relationship; and two, it's the most important to our mutual customers; and three, it also happens to be the largest part of the business, like far and away today. The unbranded processing is highly undifferentiated, it's commoditized. And as a result, it yields little to no profit. And as we go through this, we're going to be able to shed substantial cost because we aren't going to be doing that unbranded piece of it. We'll still maintain the branded, we'll still maintain the most profitable part of this business, and what is today the largest part.

But there is one other really important element. The OA, the operating agreement, also restricts PayPal from partnering with the largest and fastest growing marketplaces in the world as an MOR. So we had simply done an extension of the full operating agreement. That would have kept that prohibition in place and prevented us from becoming a fully neutral third-party platform. And the opportunity to partner with the world's largest marketplaces is immense. Today, the top 10 marketplaces that we're allowed to fully service, generate tens and tens and tens of billions of dollars of TPV, growing at 56% y-over-y. And this is just a fraction of what it could be.

So if you sum it all up for us; one, we always assumed MOR. It's in our guidance, it's in our plans; two, we think this is going to be a very manageable transition over multiple years; three, it opens up very large and very real opportunities for us to work with the largest next-generation marketplaces post the OA. And so all in, this was the best possible outcome for PayPal. We're now well-positioned to continue our strong growth both on the top line and the bottom line as we look ahead. And so we feel good about where all this has come out. We've looked at it very, very carefully. It's always been in our plans, and we feel good now that we have certainty on the direction that we're going.

<Q - Bryan C. Keane>: I just want to follow up on that. Just trying to understand. My understanding is, in 2020 that's when you guys will no longer be the MOR. And then just thinking about going forward then, my understanding is PayPal will still be a button of choice, but it just won't process some of the card payments. I'm just trying to figure out the economics, what that exactly means when you don't become the MOR, and how that impacts the P&L.

<A - William J. Ready>: Yeah. It's a great question. One of the things to understand is, as we work with many other retailers out there, they are merchants of record as we work with them. And as we are able to go command even a premium relative to card processing because we deliver greater customer acquisition, higher conversion rates, all those things, we're doing that across much of our business with the merchants or marketplace on the site functioning as a Merchant of Record.

So as Dan was commenting on earlier, we have quite a lot of insight into exactly how this plays out, and that led to us being able to fully contemplate that as we have laid our future plans, and have been doing those in separation because we know how that works at other marketplaces and other small business forums have either moved to Merchant of Record or started Merchant of Record with PayPal still as a predominant way of paying inside of those marketplaces or small business forums.

<A - John D. Rainey>: Yeah. Bryan, this is John. I would add to that maybe that, I think what you're getting to is sort of the economic impact overall, and there's a couple of things I'd point you to. First is, as Dan suggested in his prepared remarks, in terms of their percentage of our business, it's declined 900BPS over the last couple of years. And during that period, we've actually been able to keep margins flat to growing. And if you look at the 10 quarters that we've had since separation, the average revenue growth of those quarters for our eBay part of our business, has been 4%. If you look at the other 87% of our business, that has grown 23%.

So history is not necessarily – you can't project that forward, but if you were to just take those numbers and project them through to mid-2020 at the end of this operating agreement, that would suggest that in 2021, our revenue growth each year is roughly 50% larger than the entirety of the eBay business at that point in time. And so the other thing I'd point to is that, we actually incurred quite a bit of cost to support eBay today. So when we look at things like our losses or our call volume into our op center, those disproportionately skewed towards eBay relative to their percentage of the TPV. So we feel very confident that we can continue this trajectory going forward. And there's nothing about what's been announced today that changes our thoughts and our ability to continue to grow our top line and bottom line after the operating agreement.

<Q - Tien-Tsin Huang>: A couple of follow-up questions to that. Just I'm not sure if you can share how much of your profits come from eBay today, but is your ability and your confidence to maintain your mid-term guidance, does it require any sort of unusual mediation efforts, like cost cutting or share repurchase? I get the organic cost cutting or savings from the change. But just curious if it requires any extra remediation efforts or even the assumption of new marketplace wins. And if I could just pack on one more. Is it fair to think that your checkout share – the 50% number is helpful, but is it fair to think that your checkout share would be higher longer term here, just because of how integrated you've been with eBay after all these years? Sorry for all the questions.

<A - John D. Rainey>: Sure. Tien-Tsin, I'll start. The assumption that we have going forward about this is that we will continue to realize the benefits from our scale and our leverage going forward. And so this does not require massive restructuring or layoffs to continue to achieve the kind of performance that we've seen. As I suggested, we've been doing this for 2 years. And we would expect as we continue to grow other parts of our business that we can continue to generate this kind of leverage. I'd point you back to the fact that half of our cost base this year only grow at $0.10 for every incremental dollar.

Now, to the other part of your question, does that assume like anything in terms of acquisitions or anything like that? It does not. And so when we think about, if you go back to my answer to Bryan's question and you think about losing some share of that business going forward, we're talking about a few points of impact to revenue growth and profitability, and that can easily be backfilled going out and looking at inorganic opportunities. And this doesn't also address the fact that with the operating agreement ending in mid-2020, we now have the ability to go out and partner with the largest marketplaces in the world – largest and fastest-growing marketplaces in the world. All of this gives us an opportunity to backfill any kind of gap that we might have, as we transition to this next chapter with eBay.

<**A - John D. Rainey**>: Yeah. And I just also say that our guidance assumes this. So, what that means is that we knew that this was going to happen and that the guidance that we've been giving and the medium-term guidance that we put out there has assumed this happening. So, that means that we've built into our models costs and things that we know we can target and take out, revenues that we can target. So this is not everything that we haven't covered in all of our modeling and all of our plans. Otherwise, we wouldn't have been giving that medium-term guidance. This isn't a surprise. This is exactly what we assumed. It was contemplated in the operating agreement. And consequently, when I think about the experiences we've had where eBay will be at the end of the operating agreement, this multiyear transition and our place as a branded checkout solution, I feel like this will be one of these events that obviously we will have to move through it, but it will be one that's quite manageable for us going forward.

<**A - William J. Ready**>: Yeah. And one other thing I'll add, Tien-Tsin, that you talked about wins with other marketplaces, things like that. As Dan alluded to earlier and as you know, we're a primary payment platform for many of the best next-gen marketplaces in the world already, Uber, Airbnb and many others, but as Dan alluded to, not only that, many tens of billions of dollars of volume for us and growing at 50%-plus year-on-year already, the growth in that business, as we think about our other large marketplaces, the growth we see on an absolute basis is already outpacing the growth we see from eBay. So just the way that we're already engaged in these other marketplaces outpaces the growth that we see from eBay. And as we are able to contemplate engaging there in an unfettered way, we think there's a lot more opportunity ahead for us there.

You touched on one other point around share of checkout about being over-penetrated given our long historical relationship and we don't disclose specifics about the share of checkout there with – certainly it's reasonable to expect that if we see 50% approximately with other small business forums, one where we've been natively embedded over time would be a place where we, yes, are going to be strongly preferred.

And if you've seen in our consumer base, our engagement is going up consistently across our consumer base. So your point there about our share of checkout, we tend to see that as consumers are using PayPal are becoming more engaged with us over time not less, and so their preference for PayPal is increasing and so we think that bodes well for us across any marketplace we work with. And certainly, as a big part of the branded deals we've done with eBay, why that's important to both us and eBay, is the continuity of how a significant portion of their buyers have been choosing to purchase on eBay for a very long time and likely will continue to into the future.

<**Q - Sanjay Sakhrani**>: Just on that point on these other partnerships that you could have with marketplaces, how many discussions have you had with some of the larger ones that are opportunities? And how significant, economically, could those be relative to sort of what you have with eBay? And then maybe just thinking about the transaction cost element of being a lesser merchant for the networks, does that have any impact to your interchange expenses? Thanks.

<**A - Daniel H. Schulman**>: So just on conversations with other marketplaces, as part of the operating agreement, we're prohibited from offering MOR services to – I won't name them, yeah, two of the largest and fastest-growing marketplaces out there that are really directly competitive with eBay. That was part of the operating agreement. Obviously, each of them have spoken with us. We've spoken to them, but they all know that we are respecting the terms of the operating agreement because that's what eBay does as well. And so I do believe that those conversations are quite sincere, and they all do want to think about how they can work with us. But until we get closer to the end of the OA, that's when we will be able to give you more up-to-date information. Everything else to this point is confidential.

<Q - James E. Faucette>: I wanted to ask at least a additional qualitative follow-up question on eBay. And I'm just wondering how we should think about what maybe you had to agree to give or give up in terms of being able to secure the extra years of presence as checkout on eBay and make sure that you would have a presence there through 2023? And I guess as part of that, I'm curious like, why agree to whatever now instead of wait and see if there were some additional services that PayPal could deliver to eBay to improve your positioning and long-term relationship there? Thanks.

<A - Daniel H. Schulman>: Yeah. James, we thought that within the OA, this year coming up was the first year that permitted eBay to experiment with MOR capabilities. It's laid out in the operating agreement that they can choose two countries and do up to 5% of the volume on an MOR solution. So it was the right time. And we've always thought that we would never do all these negotiations at the very end. We both feel like we're going to be partners for a long time.

And we looked carefully at all parts of this deal, both the unbranded and the branded. And we felt that the unbranded piece of this was not something that made sense for us, one, because we felt the most profitable part of the business was on the branded side and it's the largest part of the business today. And number two, we in no way wanted to be restricted post the OA in terms of our ability to work with the largest marketplaces out around the globe. So for us, we felt like we didn't give anything up. So wanted to do this now. It was a natural extension. This was important to eBay. It was important to us that we both signal that we're going to be very close partners going forward. Bill, do you want...

<Q - James E. Faucette>: Got you.

<A - William J. Ready>: Yeah. And I'd just say on this point of what have we given those things. It is, as Dan was alluding to, very much like we will serve any other large retailer. So when we serve large retailers, we certainly give them rates that are commensurate with their volumes, but we're not restricted in ways of how we would do business with others or things like that. So it's very much along the lines of a standard commercial relationship that we would have with a major retailer.

<A - John D. Rainey>: Let me just add too one other thing, James. As it relates to the unbranded part of the business, volume is obviously important to us, but so is profitability. And where this was ending up is something that we weren't interested in from a profitability perspective. We can certainly go acquire volume as we've demonstrated each quarter since separation from many other places, and we have a lot of confidence and conviction in our ability to do that going forward, and do it at more profitable rates than what this unbranded agreement would have been.

<A - Paul Condra>: I just wanted to – can you just clarify a bit, I know that eBay, it sounds like they're starting this process now with Adyen. So I'm wondering when are you actually no longer restricted to start looking at partnerships with other marketplaces. And then my follow-up is just on a different topic. You did mention something about industry-standard tokens in a point-of-sale setting. I wonder if you could just give a little bit more detail about that.

<A - Daniel H. Schulman>: Yeah. I'll take the first part of that and then Bill can take the second part. So we have the ability to partner with many of marketplaces, as you probably know. We're the underlying payment platform for Airbnb, for Uber and for others. But there was a set of eBay competitors that were carved out within the operating agreement, in which we could not serve them as an MOR. And that goes away at the end of the operating agreement. So at the end of July 2020, that restriction is lifted. And eBay has the ability to start to experiment with alternative PSPs beginning this year, so they can do up to 5% of volume in two countries that they select, and then that can go up to 10% of volume within those two countries the last year of the operating agreement.

So they have a chance to experiment just as we have a chance to work with leading marketplaces out there. It's just those that you might think of as being competitive with eBay. We've been prevented from working with them as part of that operating agreement, and that makes sense for both of us, as we separated from eBay.

Bill, do you want to talk about the in-store?

<A - William J. Ready>: Yeah. And for in-store, what we're really talking about there is just the continuation of our implementation of Visa and Mastercard tokens and network-standard tokens around our in-store offerings. So as we discussed previously, we work with Google Pay and with others around in-store efforts, and we are continuing to roll out our deployment of standard network tokens around those things consistent with our Visa and Mastercard relationships that we've previously announced.

<Q - Ashwin Shirvaikar>: So can you comment on both the merchant and consumer engagement trends separately? And I think one related question is it seems payment transactions and revenue per active account are trending higher, but the payment transactions per active account decelerated as well. And then would your answer change if you separated out eBay vs. non-eBay merchant engagement? Sorry for the multipart, but just kind of wanted to get there to get an idea of that.

<A - Daniel H. Schulman>: Yeah. So in terms of the overall engagement, which grew by 8%, in my opening remarks, I said if you normalize that and the reason that seems to be decelerating is because we're bringing on so many net new actives in comparison to the years before. And so when a new customer comes on and we bring them on throughout the year, they obviously haven't ramped up to the engagement levels that somebody who has been here for a year or two have been.

So, what we take a look at is we look at every one of those cohorts that came on and we look at their engagement levels, the 2017 cohorts vs. the 2016 cohorts that we brought on, and what we see is that our 2017 cohorts, which was over 29mm net new actives, have more engagement than the cohorts that we brought in in 2016. So, what that does is that bodes very well for the future of that as those large cohorts of net new actives that are more engaged than ever before start engaging with the platform over time, that takes our engagement levels up. And so you'd actually see a double-digit increase in engagement if you normalize for the increase in net new actives.

And I think on the other things, we don't break those out and so we just do the one number, although I will say one thing, you could also see that we're having an acceleration in the number of merchants that are coming onto the PayPal platform as well. So we now have 18mm merchants on the platform that also experienced the same type of growth as we've seen with our consumer growth as well.

<Q - Darrin Peller>: Look, I mean I know you're describing the eBay contribution to be relatively minor by the time this rolls off, obviously that will give you a lot of opportunities. One of the things you mentioned was deploying capital to help diversify further. I guess I just wanted to hear more given you're now post the Synchrony deal, tax reform, there should be a ton of cash available for you guys, a considerable sum unlevered cash. So can you give us more color on potential thoughts around incremental buybacks that you've done before and then what kind of M&A, how fast? It's just been a little while since we've seen material-sized M&A. Thanks, guys.

<A - John D. Rainey>: Sure. It's good to speak with you, Darrin. This is John. So in terms of our priorities for capital allocation, those haven't changed. Our top priority is always to invest for profitable growth, and that can be both in organic opportunities, it can also be looking at the M&A landscape and we certainly, as you alluded to, given cash balance and the ability to move that cross-borders that we can be much more aggressive there perhaps than we have in the past. We are pretty rigorous in looking at all the different opportunities out there, but we're also pretty disciplined in making sure that there is the right return to create shareholder value. So you can expect us to be active there.

At the same point in time, we fundamentally believe that returning cash to shareholders is absolutely a good thing. The thing that I would want to impress upon you though is that we don't feel pressured to go out and do that immediately to try to show additional accretion or anything like that. Being measured and thoughtful in this area creates opportunities, and it creates opportunities that over the long term could pay back much more than going out and, for example, taking a large chunk of our international cash and doing a stock buyback. So we believe there's a fine balance there, and we'll do that and we'll acquire companies and return cash to shareholders as we – when the time is right for all of those, but you could expect us to be active on all of those fronts.

<A - Daniel H. Schulman>: Yeah, and I'd just say to add to John's points that we are happy with a set of assets and capabilities we have today. We've got a very robust product pipeline and we're ready to compete as a leader in the market. And I think we're playing from a position of strength. I have to agree with John. I think that our balance sheet is a strong weapon for us. With $7B of cash, we can bring in another $6B. That's strong FCF each year. And we intend to stay acquisitive and be a consolidator in the industry. We do look at hundreds of opportunities every quarter from small investments to larger ones. And there's a set of criteria that we look at. We're very disciplined. It needs to fit into our vision and mission. It needs to accelerate our progress across either a key vertical or geography or some piece of technology that we don't have. But bottom line, expect us to be acquisitive, as John said, in both a disciplined and a thoughtful manner.