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On the rebound

Evan Lorenz writes:

Losses on fixed-income portfolios and shrunken net interest margins are making 2023 a year to forget for bank-stock investors, with the KBW Bank Index down a tidy 22%. Fidelity National Information Services, Inc. (FIS on the New York Stock Exchange), a vendor of bank-related software, has similarly suffered, owing both to its customers' troubles and its own. On this slightly roughed-up equity, in preview, *Grant's* is bullish.

The acorn of the FIS family tree was the first microchip, a creation of Texas Instruments, Inc., in 1958. The invention promised affordable computing power to businesses of all stripes, but the software with which to mobilize the hardware was costly and clunky. Enter Walter Smiley. In 1968, the University of Arkansas graduate formed Systematics, Inc. to deliver affordable and handy data-processing software to small and midsize banks. As a prize in M&A contests, at least, Smiley's creation worked like a charm.

Around the horn went Systematics: It was sold to Alltel Corp. in 1990 and to Fidelity National Financial, Inc. in 2003. The title insurer spun off the software business as a separate company in 2006.

As a free-standing company, Fidelity National Information Services, or FIS to its friends, went on its own buying spree. Mega deals included SunGard, a software provider to financial-services firms, in 2015, for $5.1 billion, and Worldpay, Inc., a merchant acquirer, in 2019, for $43 billion. Former chairman and CEO Gary Norcross crowed that the Worldpay deal was "the largest ever in the financial technology industry." But not necessarily, for that reason, the best.

Through the 12 months ended Sept. 30, FIS generated $14.7 billion in sales through three business units: banking (46% of the total), which provides the software that manages such vital bank processes as customer accounts, lending systems, fraud and risk compliance, wealth and retirement products, credit- and debit-card issuance and payments remittances; capital markets (19%), which writes the software that manages records, lending and loan servicing, trading and treasury functions for asset managers, insurers, nonbank lenders and securities brokers; and merchant acquisition (33%), which encompasses the Worldpay acquisition and its messy aftermath.

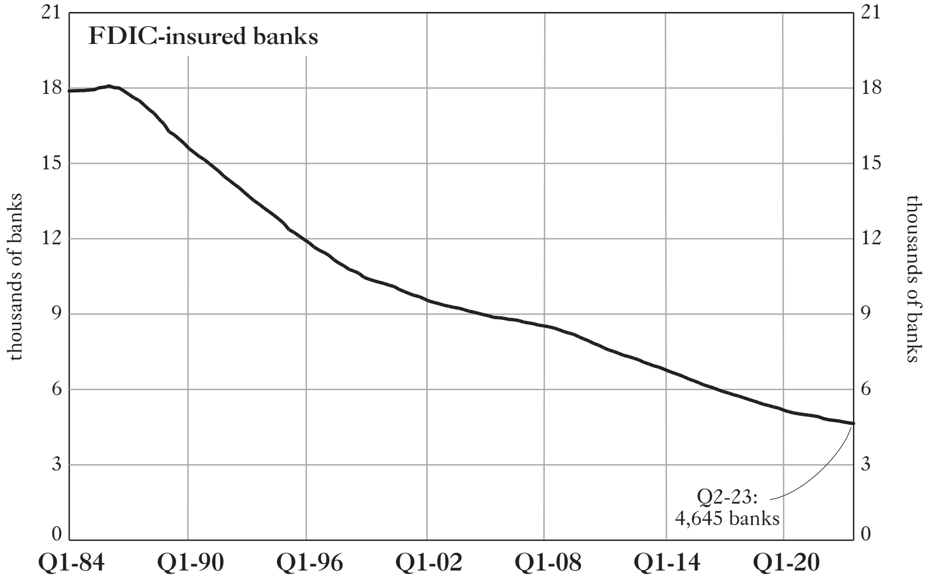
Merchant acquirers collect debit- and credit-card payments from retailers like Walmart, Inc. and send the data to card-issuing banks like JPMorgan Chase & Co., which, in turn, remit the funds to the appropriate retailers. Merchant acquirers like Worldpay take a cut of the retailers' fees.

FIS encountered two kinds of headaches with the Worldpay acquisition, the industry-wide kind and the homegrown variety. As to the former: Though the top-six competitors command more than four-fifths of the North American merchant business, a number of digital upstarts, including Adyen N.V., Block,

Not so stiff a headwind

source: Federal Reserve

Fewer banks but more transactions



source: Federal Deposit Insurance Corp.

Inc. and Stripe, Inc., are vying for market share. So doing, the newcomers chip away at the growth and margins of the established players.

PayPal Holdings, Inc. typifies another uncomfortable dynamic of the merchant-acquisition business: It's offering its customers cut-rate prices, through its Braintree subsidiary, to protect its market position against incursions from the likes of Apple Pay, Amazon Pay and Shop Pay.

Then there are the unforced errors of FIS itself. "The FIS management didn't truly understand the merchant-acquiring business very well," Harshita Rawat, who rates FIS a hold for Sanford C. Bernstein & Co., LLC, tells me, adding that, in consequence, "all the senior leaders of Worldpay left within a very short period of time after the acquisition."

Having bought Worldpay, FIS proceeded to neglect it. Competition has somewhat commoditized the core business of merchant acquisition, but alert competitors distinguish themselves by bundling software with other products and services, such as accounting systems. Payment processors typically acquire these value-adding extras through acquisitions. However, since closing on Worldpay in 2019, FIS has made only two such commitments; over the same span, each of Worldpay's publicly traded competitors made no fewer than 10, according to William Blair & Co., LLC analyst Cristopher Kennedy.

Needless to say, it would be better for FIS and its ilk if, since the spring regional-bank crisis, $1.1 trillion's worth of deposits had not fled U.S. depository institutions for higher yields and fewer scary headlines. In the second quarter, unrealized losses on bank securities portfolios totaled $558.4 billion, up from $515.5 billion on March 31.

The cull of banks backed by the Federal Deposit Insurance Corp. presents another set of problems for FIS: The banking population dwindled to 4,645 as of June 30, from 10,222 at year-end 1999 and from 18,083 in early 1986. The big, presumptively indestructible survivors, like JPMorgan, typically develop their own software. It's the vulnerable small fry that rely on FIS and its competitors (though FIS's small fry, compared to those of its competitors, are on the larger, more stable side).

Revenue growth in FIS's key banking-software unit has been below or at the bottom end of the company's long-term guidance of 3%–5% in the first three quarters of the year (adjusting for currency movements, acquisitions and lingering benefits from pandemic-relief programs) versus actual growth of 6% in 2022. Since the start of 2023, the unit's backlog of work has dipped by $1 billion, to $22.5 billion. The "unclear timing of base recovery" in the banking-software segment was one of the reasons why analyst Bryan Bergin, in an Oct. 5 coverage-initiation report for TD Cowen, slotted FIS into the no-man's-land of "market perform."

Bungling the Worldpay acquisition while overpromising and underdelivering are the proximate causes of the plunge in earnings estimates for this year, to $6.04 a share from $8.50 in late 2020, and of the companion 67% collapse in the share price since September 2020.

Activist investors JANA Partners, LLC and D.E. Shaw & Co., Inc., not failing to notice the trips and stumbles, went to the FIS board. The board, late last year, approached Norcross, showing him the door and appointing Stephanie Ferris, former CFO of Worldpay, to succeed him. An independent director joined the board to represent Shaw.

Ferris, getting right down to business, disclosed plans to spin out Worldpay. She loaded new cost reductions onto an existing economy drive while claiming to identify $500 million in "dis-synergies," i.e., new costs and lost cross-selling opportunities arising from the planned separation of Worldpay from legacy FIS.

Following receipt of "multiple expressions of interest in Worldpay from third parties," FIS is preparing to sell a 55% stake to private equity firm GTCR, LLC. The valuation is $18.5 billion, less than half of what the prior FIS management had paid in 2019. The transaction is expected to close in the first quarter of 2024 for proceeds of $12 billion.

FIS says it's earmarked $3.5 billion of that sum plus cash on hand for share repurchases (current market cap is $30.3 billion) and $10 billion for debt reduction. The completed paydown would leave "RemainCo." leveraged at 2.4 times net debt to next year's projected Ebitda.

Since GTCR raised $8.6 billion in loans and bonds in September to fund the transaction (a financing that was both oversubscribed and upsized), there seems little risk of the deal falling through. For a buyout, Worldpay will be comparatively lightly leveraged, with debt to estimated 2023 Ebitda of 4.5 times, or at the cusp of investment-grade and junk (corresponding to ratings of Ba3/triple-B-minus by Moody's Investors Service and Fitch Ratings, Inc.)

Perhaps the banking-division slump will be brief. In short order, FIS has gone through a change of command and a corporate divorce. Employees can't help but fret or cheer, gossip and text.

Add to this the fact that Ferris has reconfigured incentive pay; henceforth, the FIS sales force must focus on the profitability, rather than on the size, of signed contracts. Regional-banking woes have elongated sales cycles, too.

So far, the downshift in growth has stemmed mostly from nonrecurring sources of revenue, such as fees to set up software, early termination fees, consulting fees, etc.; these fell by 11% in the third quarter, measured year over year. Recurring revenue, i.e., the fees that banks pay FIS for the software that manages their core operations and that contributes 84% of the unit's sales, grew by 3%.

At a Sept. 7 Goldman Sachs event, Ferris said that one of her key priorities is "making sure that we deliver on our commitment and numbers and reestablish credibility around shareholder returns and shareholder values." So far, so good: In the first three quarters of the year, the rookie CEO has met and beaten the guidance she set out.

The Street is obviously unconvinced. Third-quarter results, out early Tuesday morning, were strong if somewhat confusing. Management separated Worldpay into discontinued operations and took a $1.5 billion noncash charge against the merchant acquirer. Looking through these items, one would have noticed that earnings per share of $1.65 topped consensus estimates of $1.58. Also, that the company boosted its buyback program, to $3.5 billion from $2.5 billion, and accelerated the start of share repurchases to the fourth quarter from the first quarter of next year. But the bots sold the headline, and the share price fell by 1.2%.

Providing core software to banks is a very sticky business. "These are long-term contracts on average—seven years in length," Mimi Carsley, the CFO of competitor Jack Henry & Associates, Inc., said at a UBS investor conference on Sept. 14. "It's an incredibly strenuous effort to change out your core system. You're talking about the heart and lungs of a financial organization. The [software] touches every process, every employee in a bank or credit union."

And the concentrated nature of the banking-software business makes it hard for upstarts to take share. "FIS, Jack Henry and Fiserv have about 70% of the market on a number of institutions based in the United States," Kenneth Suchoski, who rates FIS a hold for Autonomous Research, informs me. "What they're able to do is spend billions of dollars on R&D and capex. And what they can do is spread out that spending over a large number of banks. If you're a competitor trying to come in, your R&D per bank—because your market share is so low—is going to be a lot higher than that of all the incumbents."

This makes the core banking business somewhat recession-resistant. FIS's banking group grew by 3% through the lockdown year of 2020 and expanded by a cumulative 4.5% across 2008 and 2009, after adjusting for acquisitions.

Though, as mentioned, the number of U.S. banks is dwindling, the volume of banking services continues to grow—at least, the billable volume of those services keeps growing. Some 60% of the revenues of the FIS banking division are tied to the number of a client bank's accounts, 40% to the volume of that client's transactions. Together, over time, the two revenue streams have outpaced the decline in the number of insured banks.

Ferris's expressed determination to set beatable goals perhaps explains the eye-bulging cost estimates she's quoted to separate Worldpay from legacy FIS. "Have you ever seen $500 million of dis-synergies in a separation of two businesses doing $6 billion of combined Ebitda!?," Matthew Buffington, a partner at Dryden Capital, LLC, demands via email. "We couldn't find one when we looked back at all the recent spins over the past few years. . . . When we push FIS management for examples of what is causing $500 million of dis-synergies, we never really get a clear answer."

Management expected the previously mentioned cost-cutting program to offset next year's so-called dis-synergies and to boost profits in 2025. But, if Ferris is, how you say, sandbagging the impacts of the Worldpay spinoff, earnings could surprise to the upside in 2024.

In the face of the 24.7% year-to-date drop in the FIS share price, the activists have raised their stakes. In the first half of the year, JANA boosted its holdings by 1.1 million shares, to 3.7 million (currently worth $189 million), and D.E. Shaw raised its stake by 599,280 shares, to 1.4 million ($72 million).

"In 12 months, we think Wall Street will be looking at a 2025 EPS number with a $5 handle on it (excluding any equity income from Worldpay)," Buffington advises. Assigning no value to the Worldpay business and a 15 times multiple to RemainCo., FIS might be worth $75, a 47% premium to the current share price. In the five years prior to FIS acquiring Worldpay, the shares never traded below 18 times trailing earnings.

Besides, there may be value yet in FIS's 45% stake in the merchant-acquisition problem child. GTCR has

Picture of an overreaction

source: The Bloomberg

hired Charles Drucker to run the unit. He's the former CEO of Worldpay who delivered a 32.5% compound annual return from the company's 2012 initial public offering to its 2019 sale to FIS. To give Drucker the wherewithal to make the investments he needs to accelerate Worldpay's growth, GTCR says it's setting aside $1.25 billion.

The Street is friendly toward FIS, with 19 of the 33 analysts rating the shares a buy. There are no sells and few bears, to judge by a short interest amounting to just 1.7% of the float. Over the past 12 months, insiders have purchased a net 16,331 shares at a cost of $1.1 million, of which the new CEO accounted for 2,240 (for which she wrote a check in the sum of $149,430). Erik Hoag, the only seller, who garnered proceeds of $548,305, was replaced as CFO in August.

Ferris has every incentive to deliver better results and a higher stock price. On Feb. 28, she was granted 491,359 stock options. Given the intervening selloff, the shares would need to rally by 24% for those options to get into the money.

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