THE STAHL REPORT

October 18, 2010

MasterCard Inc.

(BUY)

Price:	$235.49	**Ticker:**	MA
52-Week Range:	$191.00-$269.88	**Dividend:**	$0.60
Shares Outstanding:	131m	**Yield:**	0.3%
Market Capitalization:	$30,849m		

Data as of 10/18/2010
Valuations within the text are based on a $222.59 share price.

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Investment Thesis

Update
In December of 2008, MasterCard was recommended for purchase, this being a truly contrarian position at the time, given the dramatic contraction in consumer and corporate credit that was underway during this period of the Credit Crisis that seemed to increase in severity with each passing day[1]. Retrospectively, though, this was a timely recommendation, as the shares have appreciated by 62% to the $222 level. More importantly, however, the conceptual foundation of the original thesis, which was that MasterCard could adequately sustain a period of U.S. consumer spending retrenchment, was correct. Presently, doubt is cast upon the MasterCard shares yet again, this for entirely different reasons. Apart from perhaps financial lending institutions, over the last few years, few companies other than MasterCard have continued to elicit this degree of controversy, and somewhat diametrically opposed viewpoints regarding the long-term health of its franchise.

Current Thesis
Following numerous legal obstacles that culminated with quite costly settlement payments to American Express and Discover, MasterCard has again found itself in a less than desirable legal and regulatory position. In July of this year, contained within the Dodd-Frank Wall Street Reform and Consumer Protection Act (otherwise known as the Financial Reform Act), was a provision that grants the Federal Reserve authority to regulate the company's interchange debit transaction fees. Upon news of this development, the MasterCard shares traded down sharply, beginning to recover only recently during the advancement of the equity markets this September. Nevertheless, the company's current valuation, at a 13.8x 2011 p/e, reflects what appears to be an overwhelmingly negative outcome, and certainly a long-term impediment to the historically strong MasterCard earnings trajectory.

In these regulatory matters, the uncertainty, even more so than the actual impact, can be more damaging to a company's valuation. The Federal Reserve, for example, may actually do nothing with regard to interchange debit fees. Few believe this outcome, but it is certainly possible. Yet, the operative question is - if indeed the Federal Reserve undertakes action, how will this alter the company's earnings outlook?

To begin with, MasterCard does not actually earn interchange fees. It merely establishes the rate of interchange expense paid by the merchant's bank to the issuing bank. The consensus opinion is that if the Federal Reserve sets this rate too low, the issuing banks will suffer a reduction in revenues, which might then compel them to pay lower transaction

[1] Readers are referred to the original report dated December 4, 2008, which is available upon request from PCS Research Services.

processing fees to MasterCard. If MasterCard were forced to accept lower processing fees, it would logically experience an earnings disruption of some unknown proportion.

Both the companies (including Visa) and investors really have little insight as to the ultimate outcome, given the many variables that remain unknown. The analytical task, such that it can be performed, is to simulate a possible outcome, perhaps severe in nature, as a gauging mechanism on the current valuation. Towards this end, since the new regulation will not affect the company's credit or international business, total U.S. debit gross dollar volume ("GDV") was recently $231 billion during the first half of 2010, which represented 17.9% of the total MasterCard GDV during this period. Similarly, the company reported 4.2 billion U.S. debit purchase transactions over this period, which was 28.9% of total volume. Since there is no distinction in the company's financial statements between debit versus credit card transaction revenues, one has to make a rough estimation. Therefore, let us assume that, based on the above information, approximately 20% of the MasterCard revenues are derived from U.S. debit transactions.

Let us further assume that the Federal Reserve takes drastic action to lower interchange fees that ultimately results in a 50% reduction in the debit revenues of MasterCard. This is likely far too severe, but nevertheless illustrates the following point. The net effect would be a 10% decline in the MasterCard overall revenues. Next year the consensus revenue forecast is $6.06 billion. If $606 million of revenues were lost because of regulation, the pro forma revenue figure would be $5.454 billion. Even though MasterCard has eliminated an enormous amount of expense over the past two years, let us assume that the theoretical loss of revenues is met with no reduction in the company's operational costs of $2.5 billion annually. Under this rather draconian scenario, MasterCard would produce $14.51 of earnings per share, which is only 10% below the consensus 2011 estimate of $16.19. On this stress-tested basis, the shares trade at only 15.3x next year's earnings.

Importantly, though, this regulatory change does not affect the domestic credit card interchange rate, or the international operations whatsoever. MasterCard is actually expanding its international revenues, which are now over 50% of the total business, by 20% per annum. Since this growth rate will remain protected, if one were to simplistically assume that half of the revenue base continues to grow at 20%, which results in a total company growth rate of 10%, it may well be the case that a very strong international franchise could effectively eliminate whatever outcome may befall the U.S. debit industry. In addition, the reader will be reminded that any revenue growth will likely be exceeded by the underlying earnings growth rate, given the low marginal cost of revenues, and the subsequent operating leverage. However, very few investors view MasterCard in this fashion.

Typically, a high profit margin business attracts much competition wishing to emulate similar margin success. In the case of MasterCard, its high ROE and profitability features ultimately attracted the attention of the regulators. While this cannot be viewed in any way as positive for the company, it appears that the valuation reflects an unreasonably adverse outcome. Should the earnings remain fundamentally intact, not only could the valuation rise substantially, but be based on a more optimistic earnings profile. In the interim, the company's 36% ROE and 96% earnings reinvestment rate provides alluring possibilities for an extraordinary rate of book value per share growth. Accordingly, the shares are once again recommended for purchase.

The Performance of MasterCard During the Credit Crisis

The Continuance of Margin Expansion

As noted in the initial report, MasterCard originally served a utility function for the card issuing banks to process consumer transactions. There was no real profit function for MasterCard. For instance, in 2000, the company's operating margin was 12.3%, as SG&A expenses accounted for over 80% of revenues. Since that time, though, MasterCard has dramatically improved the profitability of the business, mostly through aligning its marketing and employee compensation expenses with the prevailing revenue level.

At the onset of the Credit Crisis in early 2008, the company's SG&A expenses had been 70.3% of revenues at the end of 2007. Over the next 2 ½ years, more improvement was achieved, such that the expense level was 52.8% of revenues in 2009. The continuance of recessionary consumer spending pressures has caused MasterCard to eliminate even more costs, as the SG&A expense is currently 44.4% in 2010, which is presented below.

Table 1: The MasterCard Historical Cost Structure

Year	General & Administrative	Advertising & Marketing	Total SG&A Expenses	Revenues	**SG&A as % of Revenues**
2010 (1)	$1,782	$590	$2,372	$5,346	**44.4%**
2009	$1,935	$756	$2,691	$5,099	**52.8%**
2008	$1,997	$935	$2,932	$4,992	**58.7%**
2007	$1,857	$1,002	$2,859	$4,068	**70.3%**
2006	$1,505	$1,052	$2,557	$3,326	**76.9%**
2005	$1,351	$1,008	$2,359	$2,938	**80.3%**
2004	$1,186	$916	$2,102	$2,593	**81.1%**
2003	$1,099	$851	$1,950	$2,231	**87.4%**
2002	$965	$694	$1,659	$1,892	**87.7%**
2001	$814	$506	$1,320	$1,611	**81.9%**
2000	$737	$471	$1,208	$1,445	**83.6%**

(1) Annualized figures that are based on the 1st 6 mos of 2010

($ in millions)

One might quickly retort that, at some point, the reduction of the company's core and necessary expenses, such as advertising and marketing, which have fallen on an absolute basis by 44% since 2006, will inevitably result in a deterioration of revenues over time. In highly competitive industries, this is indeed true in many cases. However, MasterCard and Visa are virtual monopolies in payment processing. The continued acceleration of electronic payment does not necessarily require promotional expense by MasterCard. It is a natural convenience and security factor for the consumer that has little to do with the advertising efforts of MasterCard. By default, Visa and MasterCard are the only two companies capable of processing the current volume of transactions required by the issuing banks, as they have built this global processing network under the guidance of the banks for the last decade. This feature, which provides a low operating expense level mechanism, highlights the enormous operating leverage of these businesses.

Since 2008, MasterCard has managed to expand its revenues in each year, which was not widely anticipated by investors, given the severity of the ensuing recession. MasterCard, though, benefits from a long-term dynamic that, most recently, proved to be immune to recessionary pressures. That is, consumers continue to reduce their usage of cash and check-based payments in favor of electronic means such as debit and credit cards. The obvious growth regions are in Asia and Latin America, where access to credit and income are increasing rapidly. Similarly, merchants and business establishments across the globe, almost by necessity, are expanding their acceptance of credit and debit transactions. This volume-based trend more than compensated for the slight decline in the value of all MasterCard transactions last year. In the table below, it will be noted that processed transactions rose by 6.9% in 2009, while the GDV of all transactions declined by 3.3%. The net outcome for MasterCard was a 2.1% increase in revenues.

Table 2: Resiliency of the MasterCard Revenues

Year	GDV	*% Change*	Processed Transactions	*% change*	Revenues	*% change*
2010 (1)	$1,288	*12.2%*	10,997	*2.3%*	$2,673	*9.7%*
2009	$2,454	*-3.3%*	22,410	*6.9%*	$5,099	*2.1%*
2008	$2,537	*11.6%*	20,954	*11.7%*	$4,992	*22.7%*
2007	$2,273		18,752		$4,068	

(1) 1st six mos. of 2010 vs. 2009 period

GDV in billions, Processed Trans and Revenues in millions

Since the end of 2009, the value of transactions has recovered sharply, or by 12.2%. As many would expect, the recovery in the U.S. business has been tempered, and so far this year, total U.S. GDV is down 0.8% versus 2009. Over the longer term, the U.S. is not likely to provide the primary growth engine for MasterCard. Internationally, MasterCard is growing rapidly, especially in the emerging markets, which has counterbalanced lower U.S. consumer spending during the last two years, as presented below.

Table 3: International Gross Dollar Volume Growth

Year	GDV	% Change
2010 (1)	$809	21.7%
2009	$1,478	-0.3%
2008	$1,483	17.8%
2007	$1,259	25.5%
2006	$1,003	

(1) Through 1st 6 mos of 2010

Readers will recall the drastic cost reduction that has occurred since 2008. The logical effect, in light of higher revenues, has been a sustained expansion in the MasterCard operating margin. In 2007, operating profitability was 27.8%. During the depths of the Credit Crisis in 2009, the operating margin actually rose to 44.5%. Subsequently, margin expansion has continued to the present 53% level, as shown in the table below, which is quite extraordinary, given the economic circumstances over this time period. Yet, the MasterCard margin is still roughly 500 basis points below that of Visa, suggesting to the reader that more improvement is clearly possible.

Table 4: MasterCard Operating Margin Expansion

Year	Operating Margin (1)
2010 (2)	53.0%
2009	44.5%
2008	39.0%
2007	27.8%
2006	19.9%
2005	15.9%
2004	14.2%
2003	7.3%
2002	7.5%
2001	13.8%
2000	12.3%

(1) Excludes the company's various litigation settlement expenses, and charitable contributions made to the MasterCard Foundation
(2) Based on 1st 6 mos of 2010

It is not all that presumptuous to assert that MasterCard was likely one of the few companies dependent on credit availability and consumer spending that grew throughout the most recent recession. While it is not really a financial services company as commonly understood, its performance over the last two years was certainly distinguished. Since 2007, the company has recorded the following earnings per share figures: $7.96, $10.46, $11.16, and $13.60. One could easily extrapolate this performance to non-recessionary future periods; however, this is now somewhat complicated by impending future regulatory reform.

Regulation by the Federal Reserve

The Enacted Law

At this point, the Financial Reform Bill has given the Federal Reserve authority to regulate and set U.S. debit interchange rates. The Bill was passed in July of this year, and nine months subsequent to this enactment the Federal Reserve must provide its recommendations on interchange fees. Thus, in April 2011, MasterCard will no longer be able to set these rates, and the company will fall under the regulatory scrutiny of the Federal Reserve.

The Federal Reserve will be taking into consideration the cost incurred by the issuing bank for participating on the MasterCard four-party payment system in relation to the fees it receives in exchange from the merchant's bank. The goal of the regulatory framework is to determine if the current rates received are proportionate to the costs incurred. Merchant banks have long argued that the interchange fees are set too high, making it difficult for the smaller merchants or business establishments to accept MasterCard transactions.

The negative possibilities for MasterCard are numerous. For instance, if rates are reduced considerably, issuing banks may well increase the usage cost to the consumer. If this sufficiently reduces consumer transaction volume, volume on the MasterCard system could decline. Alternatively, the issuing banks could attempt to recover lost interchange fees by paying lower transaction-related fees to MasterCard, assuming MasterCard accepts this price concession. The chain of events, if viewed from this perspective, is a substantial concern to MasterCard.

Yet, it is also possible that the Federal Reserve, being mindful of the unintended consequences of setting rates too low, could adopt a far more lenient position. While few believe that the Federal Reserve will take no action, a draconian posture is almost equally eschewed.

The Impact of an Unfavorable Federal Reserve Posture

In the following exercise, the reader must accept somewhat imprecise measures, which are bound by the uncertain variables now discussed. The first, and most critical figure, is the proportion of the MasterCard business that is generated from U.S. debit transactions. On a gross dollar value basis, one can identify that 17.9% of the company's total transaction value in 2010 was attributed to the debit card program. However, MasterCard earns fee revenue based on volume as well. This suggests that 4.2 billion, or 28.9% of all worldwide transactions, were U.S. debit-based. There is really no way to precisely estimate the proportional revenues, so let us assume, based on the above information, that 20% of the company's revenues are produced from U.S. debit transactions.

In 2011, the consensus revenue estimate happens to be $6.06 billion, so the proposed debit revenues would be $1.212 billion. Perhaps the Federal Reserve will wish to reduce interchange fees so dramatically that MasterCard suffers a 50% decline in its debit revenues. All else equal, the other 80% of the company's franchise should remain unaffected. Therefore, in theory, perhaps $606 million of revenues would be foregone to due to regulatory policy decisions.

In the following table, this diminution of revenues is presented. It is presumed, further, that MasterCard could merely maintain its current operational costs without implementing any reduction measures, which the company has performed quite successfully over the past decade. If this were the case, it would generate $14.51 of earnings per share, as presented below.

Table 5: Earnings Simulation Under an Adverse Federal Reserve Rate Decrease

2011 consensus est. revenues	$6,060
50% reduction to U.S. debit business	$606
Adjusted 2011 revenues	$5,454
Operating expenses	$2,512
Operating income	$2,942
Operating margin	*53.9%*
Net interest expense	$18
Pre-tax income	$2,924
After-tax earnings	$1,901
Net margin	*34.8%*
Earnings per share	$14.51

The salient point in the above table is that the current operational expense structure, after years of refinement, actually supports this lower revenue base without causing any margin erosion. In reality, MasterCard could very well eliminate even more expense if a substantial portion of debit revenues are lost. There is a natural floor below which costs cannot fall; however, the company has yet to reach that point, such that it is a possibility at this juncture.

While the 50% debit revenue decline scenario would clearly cause the earnings to decline, the countervailing factor is that this effective 10% revenue reduction could well be mitigated by international growth. For instance, it will be recalled that non-U.S. gross dollar volume, due to areas such as Asia and Latin America, is expanding at a 20% annual rate. If one roughly assumed that 50% of the MasterCard revenues increase by 20% per annum, this is an effective 10% expansion of total revenues, thereby eliminating the impact of the U.S. reduction. Moreover, if the decline in U.S. consumer credit spending were to reverse course at some point, the domestic credit card franchise still has some growth possibilities, and the volume of debit purchases, despite the prospect of lower fees, is still increasing. It is therefore reasonably possible that the company can achieve some level of growth, although the precise rate might not be known until sometime next year.

Valuation

Current vs. Pro Forma

The current 2010 and 2011 consensus earnings estimates are $13.60 and $16.19 per share, resulting in p/e ratios of 16.4x and 13.8x. These, on a cursory basis, are not high, and are also historically low, historically being defined as fewer than five years of empirical data due to the company's IPO in 2006. There is clearly a high discount rate being applied to the uncertain earnings future of the company. Naturally, if the MasterCard earnings are going to be lower than the current consensus estimates, the shares do not trade at 13.8x, but at some higher valuation.

Based on the foregoing earnings discussion, let us assume that MasterCard will only earn $14.51 per share next year, or at least that the interchange rate regulation impact will produce this level of diminution when a possible rate reduction occurs. The implied valuation is slightly higher at a 15.3x p/e, but still quite low for a business of this quality.

If this valuation is to be accepted as a reasonable price to pay for the MasterCard franchise, such that the reader determines that a long term holding period is appropriate, it is critical to determine the company's internal, or book value growth potential over time. Since MasterCard pays very little in the way of a dividend, the earnings reinvestment rate is 96%. At the end of 2010, assuming the company achieves its second half net income estimate of $871 million, and pays the remaining $39.3 million of common dividends, book value should be $4.957 billion. Further assuming that it will only earn $1.9 billion of net income next year, which accounts for a prospective debit card revenue reduction, and will pay $78.6 million of dividends, ending 2011 book value might be $6.778 billion. The ROE next year based on these figures would be 28% that, when applied to the 96% reinvestment rate, results in a 26.9% annual book value growth rate. While the company's earnings will have to grow at a sufficiently high rate to sustain this level of book value growth, in the event that a more moderated earnings experience materializes, the prospect still for a reasonably high annual expansion of book value is good. At a 13x-15x p/e, not only is this an inexpensive price, but it also mostly disregards the ability of MasterCard to continue to expand its international operations by developing an even more extensive payment network in emerging markets that might entirely offset potential U.S. struggles.

Versus Visa and Other High ROE Companies

The only true comparison of MasterCard one can make in the valuation sense is to Visa. Visa trades at 16.4x the consensus 2011 estimate, which is a 19% premium to the MasterCard valuation. However, this tells the reader very little, because Visa is a larger franchise in terms of revenues, and produces superior profitability. Perhaps this premium is justified, so one must view MasterCard against another set of companies, presumably those with equally high returns on equity.

Table 6: High ROE P/E Comparison

	Est. ROE	2011 P/E Ratio
Google	21.4%	19.1x
Apple	31.2%	17.5x
Coca-Cola	31.2%	15.8x
Oracle	31.0%	14.6x
Ebay	15.2%	14.5x
Wal-Mart	22.2%	12.1x
Microsoft	45.4%	10.9x
MasterCard	43.2%	13.8x

Of the companies with a lower valuation, those being Microsoft and Wal-Mart, both encounter some substantial challenges that are undoubtedly reflected in their valuation. Wal-Mart, of course, dominates the U.S. retail industry, is expanding internationally, but against a base of $400 billion in revenues, it is difficult to imagine the company achieving a very high long term growth rate. Microsoft is faced with perhaps the most devastating potential outlook, which is the prospect for a gradual elimination of personal computers in favor of other computing devices produced by competing firms such as Apple.

Given the upper range of p/e ratios in this table of 14x-19x, all of these companies have certain features that could cause longer term earnings impediments. MasterCard does not appear all that disadvantaged to, let us say, Google, which will continue to face sustained competitive attempts to disrupt its domination of the internet search industry. That MasterCard trades below the valuation of all these companies suggests both an element of undervaluation, and the appearance of an unjustifiably high earnings discount rate.

Investment Summary

MasterCard is again reviewed in this publication, as its valuation, similar to the first instance in 2008, appears to reflect a far more negative earnings outcome than is likely to occur. This time around, the shares represent the possibility that the Federal Reserve may implement drastic fee reductions on its U.S. debit card business, now that this agency has the authority to regulate interchange debit fee rates. While one could assume that such a reduction will occur, given the scope of this particular business in relation to the overall MasterCard franchise, which is becoming increasingly global and less dependent on U.S. growth, the net impact on the company's earnings, even in a severe situation, appears to be relatively modest. Yet, since there will be no certainty on this issue until the Federal Reserve ultimately makes its decision next year, the share price reflects an unreasonably negative outcome. This presents the reader with an opportunity to enter these shares at a price that is overwhelmed by pessimism, and void any optimism. Accordingly, the shares are recommended for purchase.

MASTERCARD INCORPORATED

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	June 30, 2010	December 31, 2009
	(In millions, except share data)	
ASSETS		
Cash and cash equivalents	$ 2,323	$ 2,055
Investment securities available-for-sale, at fair value	829	824
Investment securities held-to-maturity	301	—
Accounts receivable	517	536
Settlement due from customers	411	459
Restricted security deposits held for customers	481	446
Prepaid expenses	332	313
Deferred income taxes	271	244
Other current assets	78	126
Total Current Assets	5,543	5,003
Property, plant and equipment, at cost, net of accumulated depreciation	435	449
Deferred income taxes	131	264
Goodwill	267	309
Other intangible assets, net of accumulated amortization of $441 and $422, respectively	390	415
Auction rate securities available-for-sale, at fair value	134	180
Investment securities held-to-maturity	36	338
Prepaid expenses	348	328
Other assets	148	184
Total Assets	$ 7,432	$ 7,470
LIABILITIES AND EQUITY		
Accounts payable	$ 244	$ 290
Settlement due to customers	456	478
Restricted security deposits held for customers	481	446
Obligations under litigation settlements	587	607
Accrued expenses	927	1,225
Other current liabilities	123	121
Total Current Liabilities	2,818	3,167
Deferred income taxes	74	80
Obligations under litigation settlements	4	263
Long-term debt	19	22
Other liabilities	392	426
Total Liabilities	3,307	3,958
Commitments and Contingencies		
Stockholders' Equity		
Class A common stock, $.0001 par value; authorized 3,000,000,000 shares, 125,553,717 and 116,534,029 shares issued and 118,813,127 and 109,793,439 outstanding, respectively	—	—
Class B common stock, $.0001 par value; authorized 1,200,000,000 shares, 12,025,947 and 19,977,657 issued and outstanding, respectively	—	—
Class M common stock, $.0001 par value; authorized 0 and 1,000,000 shares, 0 and 1,812 shares issued and outstanding, respectively	—	—

Additional paid-in-capital	3,417	3,412
Class A treasury stock, at cost, 6,740,590 shares, respectively	(1,250)	(1,250)
Retained earnings	2,022	1,148
Accumulated other comprehensive income (loss):		
Cumulative foreign currency translation adjustments	(58)	212
Defined benefit pension and other postretirement plans, net of tax	(15)	(15)
Investment securities available-for-sale, net of tax	1	(3)
Total accumulated other comprehensive income (loss)	(72)	194
Total Stockholders' Equity	4,117	3,504
Non-controlling interests	8	8
Total Equity	4,125	3,512
Total Liabilities and Equity	$ 7,432	$ 7,470

MASTERCARD INCORPORATED

CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
	(In millions, except per share data)			
Revenues, net	$ 1,365	$ 1,280	$2,673	$2,436
Operating Expenses				
General and administrative	433	507	891	955
Advertising and marketing	180	180	295	296
Depreciation and amortization	35	36	70	67
Total operating expenses	648	723	1,256	1,318
Operating income	717	557	1,417	1,118
Other Income (Expense)				
Investment income	13	14	23	31
Interest expense	(17)	(32)	(32)	(68)
Other income (expense), net	—	(3)	—	5
Total other income (expense)	(4)	(21)	(9)	(32)
Income before income taxes	713	536	1,408	1,086
Income tax expense	255	187	495	370
Net income	458	349	913	716
(Income) loss attributable to non-controlling interests	—	—	—	—
Net Income Attributable to MasterCard	$ 458	$ 349	$ 913	$ 716
Basic Earnings per Share	$ 3.50	$ 2.67	$ 6.97	$ 5.49
Basic Weighted Average Shares Outstanding	131	130	131	130
Diluted Earnings per Share	$ 3.49	$ 2.67	$ 6.95	$ 5.47
Diluted Weighted Average Shares Outstanding	131	130	131	130