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Visa, Inc. (V)

Q2 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Visa's fiscal second quarter 2016 earnings conference call. All participants are in a listen-only mode until the question-and-answer session. Today's conference is being recorded. If you have any objections, you may disconnect at this time.

I would now like to turn the conference over to Mr. Jack Carsky, Head of Global Investor Relations. Mr. Carsky, you may begin.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

Thanks, Sam. Good afternoon, everyone, and welcome to Visa Inc.'s fiscal second quarter earnings conference call. With us today are Charlie Scharf, Visa's Chief Executive Officer; and Vasant Prabhu, Visa's Chief Financial Officer.

This call is currently being webcast over the Internet and is accessible on the Investor Relations section of our website at www.investor.Visa.com. A replay of the webcast will be archived on our site for 90 days. A PowerPoint deck containing the financial and statistical highlights of today's call have been posted to our IR website.

Let me also remind you that this presentation may include forward-looking statements. These statements aren't guarantees of future performance, and our actual results could materially differ as a result of a variety of factors. Additional information concerning those factors is available in our most recent reports on Forms 10-K and 10-Q, which you can find on the SEC's website and the Investor Relations section of our website.

For historical non-GAAP or pro forma related financial information disclosed in this call, the related GAAP measures and other information required by Regulation G of the SEC are available in the financial and statistical summary accompanying today's press release.

And with that, I'll turn the call over to Vasant.

Charles W. Scharf
Chief Executive Officer & Director

Actually, Jack, it's Charlie. I'm going to start on the call.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

I'm sorry.

Charles W. Scharf
Chief Executive Officer & Director

I appreciate it though. Good afternoon, everyone, thank you for joining us. There are a series of things that I'm going to cover before I do hand it over to Vasant. I'm going to talk a little bit about our second quarter results at a high level, make some comments about the press release we put out about Visa Europe [VE], some general business updates, and then some further comments on how we see the year playing out from here.

So first let me start with our overall results. We reported earnings per share of $0.71, but this includes a one-time gain on currency forward contracts used to mitigate some of the foreign exchange risk associated with the cash portion of the VE purchase. Vasant will cover that in a little bit more detail in his remarks.

If you exclude that gain, adjusted earnings per share of $0.68 grew 7% on a nominal basis and 12% on a constant dollar basis. If you remember, we raised $16 billion in long-term debt in December of last year in anticipation of the VE acquisition, and we absorbed $125 million in interest expense during this quarter, a $0.03 drag on our EPS growth for the quarter. This negatively impacted our EPS growth rate in the quarter by five points. After we close the VE transaction, we will obviously have VE operating income to offset this expense.

As we talk about the quarter, you're going to hear some themes which will sound very much the same as those we discussed on our last earnings call, reasonable underlying domestic growth offset by some headwinds. Our results adjusting for the leap year were very consistent with the prior quarter. And our growth continues to be subdued by the strength of the dollar on both translation and cross-border business volumes, continued low oil prices, and weakness in China, oil-based economies, and Brazil. But importantly, the U.S. consumer remains strong.

Operating revenue grew 6% nominally or 9% on a constant currency basis, reflecting a negative three percentage point impact from FX. Adjusting for the leap year, growth was basically the same as the prior quarter. Overall payments volume, cross-border volume growth, and processed transaction growth were consistent with last quarter excluding the one percentage point growth benefit from the leap year. Cross-border continues at extremely low levels.

Reported U.S. payments volume growth was 11%. International payments volume growth was 14%. Cross-border volume growth was 5%. Processed transactions grew 9%. And more recently, in April through the 14th, so recognize this is a short period of time, we're seeing similar trends, with U.S. payments volume growth at 10%, cross-border volume growth of 5%, and processed transactions growth of 8%. The bottom line is we continue to see reasonable growth rates but well below what we can produce in a more favorable macroeconomic environment.

We issued a press release today regarding the Visa Europe transaction. As we discussed the transaction with the European Commission, we received feedback from them regarding the earnout. Based on that feedback, we and Visa Europe have reached a preliminary agreement to eliminate the entire earnout. Instead of an earnout, we will pay an additional €750 million at closing and €1 billion plus 4% interest payable on the third anniversary of the closing, for a total consideration of €1.750 billion plus interest.

The transaction remains subject to negotiation of a definitive document and approval of the European Commission. It's possible that we could close the transaction towards the end of the quarter, but it could slip past the end of our third fiscal quarter. We think this is a good outcome for both parties.

We've had many months now to work with the VE team up close and feel terrific about our future together, and we obviously know more now than we knew when we first agreed to the deal. Transition planning is well underway, and we have great confidence in our ability to execute this well. Given the delay in closing, we won't be providing more detailed information on this call. The basic thesis still stands, low single-digit accretion in the first full year, growing to high single digits by 2020. These numbers exclude transition costs. Next quarter we will provide more detail on what to expect after we close.

A couple of words on China, there's no real update regarding the timing regarding of our ability to apply for a domestic license, but we have been making preparations to both make our application as well as be in a position to

compete domestically. China continues to be a very important market us. We're committed to having a broader business in China that we will build over a long term, and we continue to invest locally in the country.

We announced several important partnerships this past quarter, which are great representations of our commitment to create local Chinese partnerships. First, we signed an MOU with China UnionPay, where we both agreed to collaborate on payment security, innovation, and financial inclusion. We're excited to work in partnership with CUP to lead the industry forward. The agreement provides an important platform for the two of us to work together to strengthen and create new value for the bankcard ecosystem, benefiting consumers, merchants, financial institutions, and technology partners.

We've also been active committing Visa resources to support the Chinese government's efforts to reduce poverty and promote inclusive finance. We announced a partnership with the China Foundation for Development of Financial Education and the China Foundation for Poverty Alleviation to help support progress against these goals.

And at the end of March, we signed a cooperation plan with the China National Tourism Administration, establishing Visa as a strategic partner of the U.S. China Tourism Year. This collaboration between CNTA, the U.S. Department of Commerce, and Visa will result in a year-long series of events designed to enhance tourism, trade cooperation, and cultural understanding between China and the United States.

On to some updates on client activity; in the United States, the Navy Federal Credit Union, the world's largest credit union and one of our most important clients in the U.S., renewed a multiyear credit and debit agreement with Visa. We're very proud of our association with this great institution. Beginning June 20, Visa cards will be exclusively accepted at Costco U.S. and Puerto Rico warehouse locations and fuel stations. And we continue to expand our relationships with clients across the globe. Banco do Brasil, the oldest and largest bank in South America, renewed a multiyear credit agreement. And in India, SBI Card, the State Bank of India's credit card venture, renewed a multiyear credit card agreement as well.

We continue to be encouraged by the growth we see with Visa Checkout. We have nearly 12 million registered users in 16 countries and over 675 national institution partners participating globally. Later this year, Visa Checkout will be available to merchants and consumers in six additional markets, including France, India, Ireland, Poland, Spain, and the United Kingdom. More than 250,000 merchants, including some of the largest global retailers, have signed on to accept Visa Checkout, representing $113 billion in addressable volume. Visa Checkout customers are also more active online shoppers in general, completing 30% more transactions per person than the overall population of online shoppers.

In February, we launched Visa Developer Platform, an open platform that provides access to hundreds of Visa APIs and software department kits for some of Visa's most popular payment products and capabilities. It's still very early days, but we've had strong interest early on in the Visa Developer Platform, with thousands of new users building and testing new applications in our sandbox. We have a small number of clients in or near production launch on the platform, and we expect to see more soon.

Let me just give you a simple example of how the platform changes the way we work with our clients. Earlier this year, one of our largest clients outside the U.S. sent a small team to our office in San Francisco with an idea. They wanted to give their cardholders complete control over when and where their cards worked via their mobile app, the ability to turn their Visa card on or off for certain types of merchants or transactions. Working with our team and our new APIs, they designed, built, and launched a working prototype in three days and were ready to be in market in a few weeks. Before Visa Developer Platform, this would have taken months.

I'll move on and talk about EMV for a second. Six months out from the official kickoff to chip in the U.S., we continue on the journey of moving from mag stripe to chip. More than 265 million Visa chip cards were issued as of March of 2016, making the U.S. the largest chip card market in the world and larger than the UK and Brazil combined. 47% of credit cards and 30% of debit cards have a chip on them today. More than 1 million merchants now have chip-enabled terminals, or roughly 20% of all merchants. Based on client surveys, we expect 50% of merchant locations will be enabled with EMV by the end of calendar year 2016.

One of the main pain points in moving to chip is the additional time it takes to complete a transaction due to the time the card spends in the terminal. Earlier this week, Visa announced the launch of Quick Chip for EMV. The upgrade streamlines the processing of a chip card transaction to enable customers to dip and remove their EMV chip card from the terminal without waiting for the transaction to be finalized, allowing the consumer to put away their card in typically two seconds or less. The enhancement requires only a simple software update to the merchant's card terminal or point-of-sale system. Quick Chip is available free of charge to payment processors, acquiring banks, and other networks to offer to merchants. Several merchant processors and vendors plan to offer Quick Chip to their merchant clients in the coming months, including TSYS, Ingenico, Verifone, Equinox, and V2.

Before I turn the call back to Vasant, I want to say a few words about the back half of the year and our guidance. Vasant will walk through the specifics of the changes in our guidance, but a few quick comments. We've not seen improvement in the global economic environment. Relative strength of currency pairs is still unfavorable for us, and the price of oil has remained at low levels. As we discussed last quarter on our earnings call, our guidance assumed that these things would improve.

Since we're now in the third quarter, we're far less comfortable that volumes will meaningfully change, so we're officially reducing some pieces of our guidance, especially the third quarter. We could be wrong. We don't know what the global economy will look like beyond tomorrow. It could improve. And when things improve, we will be the beneficiaries. But as of today, with a few exceptions, our business volume growth is not accelerating or decelerating, but we're obviously still seeing meaningful growth.

We do know that there will be a turn at some point for the better. We just don't know when. So our mindset continues to be cautious in the short term due to the headwinds discussed earlier, but the long-term fundamentals of our business model remain strong, and our focus is on accelerating global electronic payments. Globally, an estimated 43% of all consumer payments today are still made with cash, which leaves us an enormous opportunity in addition to the growth that we see due to regular economic growth for PCE [Personal Consumption Expenditure]. Last week Visa published a white paper, located on our website, discussing the opportunities to accelerate the growth of global acceptance, and I encourage you to take a look at that paper. It's why we feel good about the work we've done. There's still great opportunity in front of us.

With that, I will turn it over to Vasant.

Vasant M. Prabhu

Chief Financial Officer & Executive Vice President

Thank you, Charlie.

Much like our first fiscal quarter, the global macroeconomic environment remained uncertain, but our business performed well. A few points to highlight; first, net revenues grew 9% in constant dollars, with an expected three-point drag from the strong dollar. Nominal revenue grew 6%. The one-point step up in the growth rate relative to the first quarter was mostly due to the leap year effect.

Cross-border business was once again very weak but in line with the first quarter's growth rate. The deceleration of outbound commerce from China continues. Cross-border commerce out of commodity-based economies remained anemic. This has added to the negative effects of the strong dollar, especially on our large inbound U.S. business. However, currency volatilities were higher than the first quarter, offsetting some cross-border weakness.

Through the first six months, we managed our expense growth to 4% in nominal terms, well below the high single-digit rate we had planned in the first half. We have continued to hold the line on expenses while funding all our key growth initiatives, such as Visa Checkout, Visa Token Service, Visa Developer Platform, and others.

During the quarter, we entered into currency forward contracts to mitigate the exchange rate risk associated with the upfront cash payment for Visa Europe. As these contracts do not qualify for hedge accounting, they are mark to market, with gains or losses recorded in non-operating income. We recorded a $160 million gain, which we have excluded from our reported EPS as a non-GAAP adjustment. These contracts are expiring in late April. When it became apparent that the Visa Europe transaction would not close before then, we entered into fully offsetting contracts at the end of March, locking in this gain. Coincidentally, this gain is almost equal to our interest expense in the quarter.

Lastly, we repurchased 24.2 million shares during the quarter at an average price of $72.23 per share, for a total of $1.8 billion. Year to date, we have bought back 49.9 million shares at an average price of $75.47, for $3.8 billion. At the end of the quarter, we had remaining stock buyback authorization of $4 billion.

Now a quick review of the quarter's business drivers; note that all growth rates are about a point higher due to the leap year effect. Global payments volume in constant dollars grew 12%. Despite considerable uncertainty and turbulence in the global economy, payments volume growth globally has been remarkably stable. U.S. payments volume grew 11%, with both credit and debit growing at the same rate. Accounting for conversions and the leap day, U.S. payments volume growth was slightly lower than the first quarter.

International payments volume grew 14% in constant dollars, consistent with the last quarter. Once again, the impact of the strong dollar reduced nominal growth in international payments volume to a paltry 4%.

Cross-border volumes grew 5% in constant dollars and were flat in nominal dollars. When you factor in the leap year, the trend was unchanged from the first quarter. Cross-border growth rates in constant dollars have decelerated from 9% in fiscal year 2014 to 17% last year, down to 4% so far this year. As we mentioned on our call last quarter, the first leg down was driven by the strong dollar. And then starting in September last year, growth decelerated sharply due to China and the commodity price collapse.

Cross-border commerce outbound from China has dropped from growth rates above 40% a year ago to single-digit levels in the second quarter. Commodity-based economies across Latin America, the Middle East, and Africa have also experienced sharp declines. This has hit our large U.S. cross-border acquiring business hard. Commerce into Europe has been strong, though we do not benefit fully from it yet. More recently, we have seen commerce outbound from Europe into the U.S. pick up.

Processed transactions totaled $18.5 billion in the quarter, up 9%. Both U.S. and international growth at 12% and 1% respectively were stable. Processed transaction growth rates will step up in the back half of the year as we begin to lap last year's transfer of domestic processing in Russia to NSPK.

Service revenues grew 8%, in excess of nominal payments volume growth of 5%. The pricing we took last year contributed three points to the growth rate. Next quarter we will lap the price increases, and this three-point tailwind will no longer help us. Data processing revenue grew 10%, in line with processed transactions.

International revenues grew 8%. Constant dollar cross-border volume growth of 5% was almost entirely offset by the currency translation drag. The year-over-year increase was largely driven by the pricing actions from last year. Currency volatilities were high in the quarter but only contributed modestly to growth, as we are now beginning to lap high volatilities from last year. Next quarter our reported international revenue growth rate will no longer benefit from the price increases. And as I mentioned, currency volatilities were unusually high in the second half of 2015. As such, going forward, reported international revenue growth will depend on the interplay between volume growth and the currency translation drag.

Other revenues were down 3%, primarily as a result of lower license fees generated outside the U.S. due to slowing payments volumes. Incentives were generally in line with our expectations, at the midpoint of our guidance range. Higher U.S. incentives due to acceleration of deals into the quarter were offset by lower incentives outside the U.S. due to lower volumes.

With expense growth in the mid-single digits, a tax rate of 30.1%, EPS of $0.68 after adjusting for the gain from our currency forward contracts, grew by 12% in constant dollars, and by a healthy 17% when you account for the interest on the debt we issued to finance the Visa Europe acquisition.

With that, let me turn to our outlook for the fiscal third quarter and the balance of the year, which excludes the impact from Visa Europe. We now expect net revenue growth in fiscal 2016 to come in at 7% to 8% in constant dollars, a couple of points below our expectations from last October. This is driven by three factors: first, no improvement in cross-border volume growth from current levels; second, somewhat weaker domestic payment volumes due to gas prices as well as weakness in large commodity-based economies like Brazil; third, client incentives likely to come in at the high end of our 17.5% to 18.5% range.

In October last year, as we told you on our call, we had hoped that cross-border trends would improve as we lapped the weakening of the dollar in the second half of fiscal 2015. However, cross-border growth dropped from the 8% range to the 4% range in the past six to nine months, as outbound commerce from China and commodity economies slowed sharply. This trend continues. As such, we are assuming little improvement in the cross-border growth rate in the second half. Recent weakness in the dollar should help over time, but it is too early to tell.

We have now lapped the sharp gas declines from last year. Last October, we had hoped that this would provide a tailwind for U.S. domestic volumes in the second half of fiscal 2016. This has not happened, as gas prices remain below the lows of last year. Given the recent failure of OPEC to agree on production caps, lower gas prices could persist. As such, we are assuming that U.S. payment volume growth will not improve from current trends in the second half. In addition, payments volumes remain soft in large commodity economies like Brazil and the Middle East.

Client incentives are projected to come in at the high end of our guidance range. In the first half, client incentives were around 18% of gross revenue. In the second half, we are likely to run at around 19%. Significant renewals and conversions are driving this trend, particularly in the U.S. Costco and USAA add more than 50 basis points to incentives as a percent of gross revenues in the second half.

A few other factors to highlight, these are not new but will impact reported revenue growth numbers in the second half. As I mentioned earlier, we will no longer benefit from the uplift in our growth rate we got from the price increases last year. We will lap the currency volatility peaks of the second half of 2015. There have been some delays in the rollout of USAA and Costco conversions. Given the quarter lag in recording service revenues, these Costco and USAA conversions are a drag on net revenues in the second half of 2016. In other words, incentive

expense exceeded revenue recognized. This will of course not be the case in fiscal 2017. On the positive front, if the recent weakness in the dollar continues, the currency translation drag of three points could moderate.

Given softer than expected revenues, we will continue to hold the line on expenses, funding key strategic and growth programs while maintaining or reducing costs in other areas. As we had indicated previously, expense growth will be lower in the second half relative to the first half rate.

We expect a modestly lower tax rate of about 30% versus the low 30%, which will also help mitigate impact on net income.

As you look at the fiscal third quarter, net revenue growth in nominal terms could come in as low as 2% to 3%. In addition to the factors I just mentioned, we will lap an unusually low quarter for incentives in Q3 last year. Incentives were 16% of gross revenues due to deal delays versus an anticipated 19% this year. As we have told you before, incentive shifts from quarter to quarter can impact year-over-year comparisons. Nominal net revenue growth should revert back to the first half growth rate in Q4.

With a lower revenue growth range and including interest expense from the $16 billion in debt we issued last December, we now expect constant currency EPS growth in the low double digits. Interest expense will cost us over $0.09 this year, or almost four points of EPS growth. If you account for the interest expense, it puts constant currency EPS growth at the low end of the mid-teens range. The currency translation drag is approximately four points.

In terms of the impact of Visa Europe, for modeling purposes, we think it is best to assume the transaction does not close in our fiscal third quarter. As such, we will have interest expense in the third quarter but no operating income from Visa Europe to offset it. Should we close on the acquisition sooner, we will of course break out the impact. If Visa Europe is in our numbers for the full fourth quarter, in rough terms it will offset interest cost in the quarter. There will of course be a variety of non-recurring transaction related costs, which will also break out. We hope to give you a more precise perspective when we talk again in July.

As we look ahead to 2017, we remain optimistic that revenue growth rates will step up from current levels. We will begin to see the impact of Costco and USAA conversions kick in, and hopefully we will see some recovery in the cross-border business and gas prices, helped by a weakening dollar. Nominal dollar growth could also pick up as the dollar drag abates. Visa Europe will provide additional ballast, driving EPS growth back to levels you expect us to deliver.

With that, I'll turn this back to Jack.

Jack Carsky

Global Head of Investor Relations, Visa, Inc.

Thanks, Vasant. I got it right that time. Sam, at this point we are ready to start taking questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question is from Moshe Orenbuch with Credit Suisse. Your line is now open.

Moshe Ari Orenbuch
Credit Suisse Securities (USA) LLC (Broker)

Q

Great. So it sounds, Vasant, like you're saying that the revenue weakness comes from the rebound that you were hoping for not really happening. I'm wondering. Can you talk a little bit? You mentioned the tax rate, but it seems like even including the interest expense that the impact on net income is actually fairly nominal. Are there other things going on, and can you talk a little bit about what you're doing to preserve or protect net income?

Vasant M. Prabhu
Chief Financial Officer & Executive Vice President

A

As we've been doing most of this year, we are holding the line on expenses. I think when we talked to you last October, we had indicated that the expense growth would run I think in the high single digits in the first half and then moderate in the second half. It has, as you can see, run below that in the first half, and we said that the rate will be even lower in the second half. So clearly we are trying to mitigate some of the revenue softness with expense management. And then the tax rate is modestly lower than we might have expected last year. So those two things are mitigating the impact on EPS, but not completely. But other than that, really, those are the main pluses and minuses. I don't know, Charlie, if there's anything you would add.

Charles W. Scharf
Chief Executive Officer & Director

A

No.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Next question.

Operator: Yes, our next question is from Jason Kupferberg with Jefferies. Your line is now open.

Jason Alan Kupferberg
Jefferies LLC

Q

Hey, thanks, guys, just two quick ones related to Europe. First, any other regulatory impediments that you anticipate now that you took care of the earnout? And how much would you expect Visa Europe to drive acceleration in the cross-border volume given all the intra-European travel? I think you had given some pro forma data on that couple years ago. So I don't know if the relative figures would have changed, but any thoughts there?

Charles W. Scharf
Chief Executive Officer & Director

A

I guess I'll take the first one. So we have to obviously go back and get approval for this transaction. But as I had said in my remarks, we have gotten feedback. It's specifically related to the earnout. And so what we've crafted

eliminates the earnout in its entirety. So as with all regulatory approvals, we need to go through the process, but we would not have struck a deal that we didn't think could be approved.

Vasant M. Prabhu
Chief Financial Officer & Executive Vice President

A

On the cross-border question, if you go back three or four quarters and look at cross-border inbound/outbound, one of the strongest markets for inbound travel and inbound commerce has been Europe. So had we had Europe in our numbers, clearly our cross-border numbers would have looked better. What's it going to be like next year? Of course, that's a different issue, and we'll talk about it in the next few quarters as we discuss Europe. But yes, cross-border inbound into Europe has been a strong business.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Next question?

Operator: Thank you. Our next question is from Sanjay Sakhrani with KBW. Your line is now open.

Sanjay Sakhrani
Keefe, Bruyette & Woods, Inc.

Q

Thank you. I just want to make sure there's no other contingencies outside of the EC approvals, is there, to close this deal. And then just secondly, understanding it's a competitive market today, is there any concern that the removal of the earnout loosens the ties that the banks might have in the future with Visa Inc.? Thanks.

Charles W. Scharf
Chief Executive Officer & Director

A

Sure. So listen, on the second one, I think as I said in my remarks, we've had a fair amount of time to work with the Visa Europe team to understand their relationships with their clients. And I would just say that we would not have agreed to a deal that we didn't think was an appropriate price to pay relative to the value that we were getting. Our view is when you actually look at what the earnout was versus where we are today, we're confident in the value that we'll be getting and we will get the appropriate returns.

And on the first question of regulatory approval, there were three that we initially needed to approve, Turkey, Jersey, and the European Commission. And we will revisit the first two to ensure, and we will go through the process with the European Commission.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Next question, please?

Operator: Thank you. Our next question is from James Schneider with Goldman Sachs. Your line is now open.

James Schneider
Goldman Sachs & Co.

Q

Good afternoon, thanks for taking my question. As you think about the Visa Europe integration process, can you maybe give us an update on the process you're going to go through in terms of identifying synergies? And can you maybe talk about any synergies that you might look for in Visa Inc. in addition to those in Visa Europe?

Charles W. Scharf
Chief Executive Officer & Director

A

Yeah, let me start and then Vasant can chime in. The work that we've had underway, and keep in mind, just to be perfectly clear, as we have done our work since the announcement of the initial transaction, all the work that we've been doing is just pure planning. They continue to run their business. We continue to run our business. But we've been working very closely together to understand what the best way to organize and run the company is on a going-forward basis.

So we've gotten to the point where we have pretty clear plans area by area across the company of what the expense base of an integrated company would look like, what timeframes would look like to get there. We have some more process to go through and we've got some specific processes we've got to go through within Europe to ensure that we do this properly. But when we first announced the transaction, we had done the work with some information but not the kind of information that we have had access to since the transaction was announced.

So as I said, we feel very comfortable that we have a better understanding of what those expense synergies will look like and over what time we will get them in addition to having a deeper understanding of what it will take operationally, and feel very good about our ability to get it done.

Vasant M. Prabhu
Chief Financial Officer & Executive Vice President

A

Yeah, I think everything we told you then as to what we can do we feel very good about, have much clearer line of sight on precisely how we would do it and over what timeframe. And then to answer the other question you asked, would we look at costs comprehensively and say what is the opportunity when you combine the two both within Visa Inc. and Visa Europe? Yes, we would absolutely do it that way across the functions.

Charles W. Scharf
Chief Executive Officer & Director

A

Yeah, and so just to be very specific, there are some things where we look at what's being done in Europe, and we asked the question. Are they doing it better and more efficiently than we're doing it elsewhere in the Visa Inc. franchise? And if that's the case, which it is in some cases, that could survive and we'll get the synergies within VI.

Vasant M. Prabhu
Chief Financial Officer & Executive Vice President

A

That's right.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Thank you; next question, please?

Operator: Our next question is from Bryan Keane with Deutsche Bank. Your line is now open.

Bryan C. Keane
Deutsche Bank Securities, Inc.

Q

Yeah, hi, guys. Just wanted to make sure. Last quarter you guys warned that if there wasn't a pickup on the economy front, we're likely to see potentially changing guidance, so not a real surprise here. But what I want to make sure is, is this all cyclical, or is there any share loss that you're seeing that's causing the change in guidance?

And then secondly, we picked up some news that you guys could be increasing your U.S. acquirer fee on Signature Debit on July 1, 2016. Just want to see if that has any impact on the model and if that's correct. Thanks.

Charles W. Scharf
Chief Executive Officer & Director

A

So let me do the first one first. So to answer the question, everything that we're seeing and everything that we've talked about we absolutely believe is cyclical. It doesn't relate to share in any way, shape, or form and we feel very good about the maintenance of the share that we have across the world.

And you're right, I'm glad you pointed it out because we tried to be as transparent as we could on last quarter's earnings call, where we said listen, it's the first quarter. It's very early. We don't know what volumes will be two, three quarters out from now. But our assumptions are that in order to make those guidance numbers, there needs to be an improvement. And things haven't deteriorated, but things haven't improved, so that's playing out exactly – not the way we would want, but given what's happened, the way we would expect. And so obviously, if things got better, then that would change as well. But we just don't see that. And so it's not something at this point, given that we're already in the third quarter, we think is prudent to think about.

Vasant M. Prabhu
Chief Financial Officer & Executive Vice President

A

And in terms of the U.S. acquired debit price increase of two basis points, yes, we have informed people about it. They will begin to see the increase in July. But as you know, we record these things on a quarter lag, so there's no benefit from the price increase in this year's revenues.

Also, just so that you're clear on it, this is not in any order of magnitude terms anywhere close to the price increase we took last fiscal year, so the impacts are more modest. It's clearly helpful, and of course we provide some level of remediation in the early months. So you should make sure that some of that is factored in as you think about all this.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Thanks, Bryan; next question?

Operator: Our next question is from Darrin Peller with Barclays. Your line is now open.

Darrin Peller
Barclays Capital, Inc.

Q

Thanks. So I just want to clarify. It sounds like despite the run rate for the first half of about 8.5% constant currency, the low growth in the third quarter is the timing of incentives, and it sounds like a little bit of a delay in timing on Costco/USAA. Can you just – any reason for the slower implementation of those, and is the timing for those deals now around the fiscal fourth quarter or early next year?

And then just a quick follow-up on the incentive size. I guess when we go forward, had those been in line with the timing of incentives in the third quarter, would your incentive run rate still be in the midpoint of the range? Is that really what we should expect going forward? Thanks, guys.

Charles W. Scharf
Chief Executive Officer & Director

A

On the first one, it's hard to pinpoint it. And the implementation of the Costco arrangement is in a lot of respects out of our hands. Remember, they had an agreement that they had to unwind. There's a lot of work that Citi, the issuer, and Costco are working as well as us. And so given the complexity of unwinding an old agreement and moving forward on a new agreement is just complex. And in USAA's business, there's nothing specific other than I think it's them just wanting to do it in a timeframe which brings about the least amount of potential issues for their members, which we respect.

Vasant M. Prabhu
Chief Financial Officer & Executive Vice President

A

And on the level of incentives then, we are in the range we told you coming into the year. We are at the high end of the range. And the reason for that is we've had a significant number of renewals around the world and in the U.S. And of course, we've had a couple of big conversions. That's all in our view good news in that we are re newing important contracts and we have some significant new business. As I mentioned in the comments, the benefits from the conversions for sure are not showing up this year and will show up next year. But some of these, as we've told you before, there are timing moves from one quarter to another. And there's no question that the incentives are running at the higher end of the range because these renewals have mostly all now fallen into place.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Thanks, Darrin; next question, please?

Charles W. Scharf
Chief Executive Officer & Director

A

I would just say listen, I think to that point, and the reality is these are important renewals. These are very big clients and the new wins we've talked extensively about. And so when we talk about it in terms of how it impacts the numbers, if you just step back for a second and to the question earlier about share, we feel really, really good about what our client franchise looks like for sure across the globe.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Next question, please?

Operator: The next question is from Andrew Jeffrey with SunTrust. Your line is now open.

Andrew Jeffrey
SunTrust Robinson Humphrey, Inc.

Q

Hi, thanks for taking the question. I appreciate it. Charlie, I wonder if you could maybe opine a little bit on mobile payments adoption, mobile wallet adoption in particular. It seems like some of the big banks indicated recently that it remains quite low and maybe a little disappointing. Are there any implications longer term for Visa's volume around mobile one way or the other? And how do you think about initiatives that Visa might undertake to accelerate mobile adoption which might benefit the secular shift?

Charles W. Scharf
Chief Executive Officer & Director

A

Sure. I think it's interesting. I think we are doing as much as we can as an entity to insert ourselves in a way which benefits all of our clients and their clients into helping digitize payments in all forms of commerce, and that's how we think about it. We don't necessarily think about that we want to drive business from cards to e-com, to m-com, or anything like that. Anyone who tries to drive something towards what they think is good for them generally hasn't been particularly successful. And so what we want to ensure is that we continue to have the best solutions to pay in the physical world, that we've got the best solutions to pay in the e-com world, and the best solutions to pay in the m-commerce world.

And so if you look at the things that we've done all across that spectrum, whether it's the things that you see, such as Visa Checkout, some of the things that we've done with third-party players, whether it's Google, Samsung, or Apple, or whether it's things that you don't necessarily see, like tokenization, these are all aimed at ensuring that we are a preferred payment option in all of those different mediums. And quite frankly, the consumers and the merchants are going to be the ones to drive the adoption of these different forms of payment.

And so we're there to support them. We're there to be their partner. We're there to provide options. So the work we did on tokenization enables a lot of the things that you're seeing out there, but we don't prefer one versus the other. We just have to ensure that we're doing everything we can to be inserted into all forms of commerce in a way which is friendly for our issuers and acquirers.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Thanks, Andrew; next question, Sam.

Operator: Our next question is from Matthew Howlett with UBS. Your line is now open.

Matthew P. Howlett
UBS Securities LLC

Q

Thanks, guys. Just as a follow-up on the cross-border, what is a normalized run rate? Maybe first start off with what you're seeing in terms of what corridor is it. It looks like the Asian region is coming in a little bit slower. Then, what do we expect is a normalized run rate and what should we expect long term?

Vasant M. Prabhu
Chief Financial Officer & Executive Vice President

A

If you go back in time, as you know, double-digit run rates were very common. And then starting about eight quarters ago, you started to see some slowdown, mostly with the strong dollar. And that dropped the run rate down to the single digits, and it ran at about 8% – 9% in constant dollar terms for a while. And then in October or so last year, we saw that sharp decline to 4%, and it stayed there. The biggest drivers are significant declines coming out of China, and that has not changed. In other words, the second derivative on that is still negative. It is continuing to decelerate, though still positive.

Canada, a major source of business for us in the U.S., has been declining for several years now. It has gone from a growth rate to meaningful negative levels. Then we saw a significant change in trend in the past few months coming out of all of the commodity economies, whether those are the African economies or the Middle East, big declines in those areas. And then layered on top of that are specific large economies like Brazil, which for a while

which was a major source of outbound business to the U.S. and elsewhere; and other economies, like Russia, which you saw really slow – go down significantly last year.

So you've got three things going on at the same time, which may not happen often. One is a strong dollar, which hurts the largest part of our cross-border business, which is the acquired business into the U.S. Second is a significant growth engine called China slowing down. And third is large chunks of the global economy having trouble, like Brazil, like Russia, for a variety of different reasons. So you've got all three things happening at the same time right now.

Charles W. Scharf
Chief Executive Officer & Director

A

And just in terms of how it plays out mathematically is – remember, to the extent that the dollar strengthens, we start to see less spending as goods are no longer as attractive to buy on a cross-border basis. And so you're going from growth to shrinkage, and so on a percentage change basis it's significant. So the first effect will be at some point these things get lapped, assuming that it doesn't continue to get worse, and normal business grows at a reasonable level. And then if there is any kind of weakening of the dollar, then you start to see the spending patterns shift back to what they were, and that changes the growth dynamic significantly.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Next question, Sam.

Operator: Yes, our next question is from Jamie Friedman with Susquehanna Financial. Your line is now open.

James Friedman
Susquehanna Financial Group LLLP

Q

Hi, thanks. It's Jamie at Susquehanna. I was just wondering, Charlie. Do you have any update on your conversations, negotiations with the aggregators that you had shared some perspective on last quarter? Thank you.

Charles W. Scharf
Chief Executive Officer & Director

A

I don't, I don't. I think what I said is what I and we continue to feel. And if there's anything more to talk about, we'll let you know.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Next question, Sam.

Operator: Yes, our next question is from Lisa Ellis with Bernstein. Your line is now open.

Lisa D. Ellis
Sanford C. Bernstein & Co. LLC

Q

Hi, Charlie. Can you give an update, a little more color on Visa Checkout? How many of your large issuers do you have now auto-enrolling in Visa Checkout, and are you seeing a notable uptick in adoption as a result of that? And then similarly on the acquirer side, do you have any acquirer partners that are actively now helping you promote

Visa Checkout with the merchants? Like at some point here, should we be seeing more of a steep acceleration in adoption?

Charles W. Scharf
Chief Executive Officer & Director

A

Listen, I think to the last question first, I think it's – we don't – when we think about what the adoption curves look like, we're not looking for anything that looks exponential necessarily at this point. In fact, what we want to see is we want to ensure that there is continued growth on both sides of the equation, so not just the increase in the user base, but the increase in the merchant locations as well. And anytime those – if those growth rates get way out of line, then we live somewhat in fear of one side of the network getting ahead of the other.

So we have Bank of America who is very actively promoting Visa Checkout. That has just begun. So it's hard to draw any conclusions to what it means, but we love what they're doing. It is very simple. It's very creative, and we're excited about it. Beyond that, we're very focused on growing the merchant side. And the reality of the merchant side, Lisa, is it really is – it's merchant by merchant.

And so we can certainly – we've done everything that we can to make it a simple integration for merchants. But the conversation really is, it's not even necessarily – it's not the typical conversation that either we or an acquirer have with a merchant where we're talking about acceptance or we're talking about an assistant treasurer. The conversations with Visa Checkout are much more about the marketing areas. And so that is where we are focused on is getting the conversation to a different level with merchants, and we're focused on the top merchants, not necessarily the number of merchants or the size of merchants.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Thanks, Lisa; next question, please?

Operator: Yes, our next question is from Tien-tsin Huang with JPMorgan. Your line is now open.

Tien-tsin Huang
JPMorgan Securities LLC

Q

Great, thanks. Good afternoon, just a couple questions. The Costco card has pretty attractive rewards. I'm curious. Does that change the incentive equation for Visa in any way, meaning your role in funding those rewards?

And I want to ask a Visa Europe question just as part of the new deal giving up the earnouts. Do you get to then extend contracts with the major issuers from Visa Europe? I was just curious what the give-and-take is beyond what you discussed. Thanks.

Charles W. Scharf
Chief Executive Officer & Director

A

Sure. The first question was...

Vasant M. Prabhu
Chief Financial Officer & Executive Vice President

A

Are we doing anything different with Costco because the rewards are better?

Charles W. Scharf
Chief Executive Officer & Director

A

No, no. Our deal with Costco is our deal with Costco, and their deal with Citi is their deal with Citi. And so we love the product that's out there. And even more broadly, we love Visa acceptance at Costco for all of our issuers.

And on the second item, the answer is no, there's nothing special that goes along with contract renewals or anything like that relative to the additional amount that we're paying. But I think – I guess the way I would think about this is we certainly when we entered into the earnout, wind up with a point of view of what we think we could pay based upon the results could pan out. And as I said earlier, we've had the opportunity to be able to have a deeper level of understanding of what that could actually be, as well as to have an understanding of what the relationships between Visa Europe and its client base are. And so I just don't know how to say it other than I think we feel very good about the deals that we've struck, just as I'm sure their members feel very good on a risk-adjusted basis they're getting more guaranteed of cash, and so these two things meet at a place where you get a transaction done.

Vasant M. Prabhu
Chief Financial Officer & Executive Vice President

A

Yeah, and everything we've seen and heard indicates that the current members and the current big issuers and customers of Visa Europe actually see Visa Europe as being part of Visa Inc. and one Visa as a big plus. Makes Visa Europe much more attractive from their standpoint with all the capabilities that we are bringing. And in any case, we had always assumed that we were going to work with every one of these issuers to move the relationship from a member relationship to a commercial relationship. And those conversations will clearly be the important things we do with them as soon as we're able to.

Charles W. Scharf
Chief Executive Officer & Director

A

I guess I would just pile on a little bit and say, if there's a belief that banks have continued to do business with Visa Europe solely because of its ownership structure, that's a very risky thought process to go down.

As we all know, the payments business is extraordinarily important for financial institutions. And as we pointed out on these calls many times, these are financial decisions about the network that they're choosing, but they're also far greater strategic alliances that they're thinking through. And what we bring is just a tremendous amount more to the banks in terms of capabilities. So the relationships that Visa Europe has are very, very strong, and what we have is additive to that. So we feel very, very good about our ability to compete in an open marketplace with others for the banks' business.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Thanks, Tien-tsin; next question, Sam?

Operator: Our next question is from Bob Napoli with William Blair. Your line is now open.

Robert Napoli
William Blair & Co. LLC

Q

Thank you. Vasant, you had mentioned I think just on the Costco incentives and the high end of the range for client incentives for the back half of this year. As we think about 2017, I think you said that we would expect Visa to deliver earnings like investors are accustomed to. And I was wanting for some color on that.

And then is the Costco and USAA, are there portions of the fees that are one-time very large fees such that we shouldn't expect the high end of the range longer, that type of a range longer term, or should we think of the higher incentive range longer-term?

Vasant M. Prabhu
Chief Financial Officer & Executive Vice President

A

There were several questions there. Hopefully, I remember them all. In terms of the Costco business, all I was saying was that it wouldn't have an impact on 2017. I'm forgetting all the questions. There were several questions there. Jack, can you help me?

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

The first piece was what are the returns or earnings you would expect.

Vasant M. Prabhu
Chief Financial Officer & Executive Vice President

A

Oh, right, you made some reference to earnings. I just want to make sure that we were just making sure people understood that this year we had two big things going on that hopefully we won't have to deal with next year. One is we have this interest expense, which clearly did not have offsetting operating income in the timeframe that we expected, and that was a meaningful drag on our earnings this year. And clearly, once the Visa Europe deal closes, we will have the offset. That was the intent of the debt issuance. So that was clearly almost a full point of drag on growth, and we just want to make sure people were aware of that.

Second, we have seen the headwinds that we talked about coming into the year. We are hopeful that they will moderate as we go into next year.

And then third, the conversions that we believe will add some additional ballast, so to speak, to revenues really aren't helping us, in fact, are a drag this year because of this lag issue. So all I was doing was pointing to those things. We'll talk about it next year at the appropriate time and give you our best sense for next year. I think we were just highlighting some of the elements of this year that were fairly unique.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Thanks, Bob; next question, please?

Operator: Our next question is from Chris Donat with Sandler O'Neill. Your line is now open.

Christopher R. Donat
Sandler O'Neill & Partners LP

Q

Hi, good afternoon. Thanks for taking my question. I'm curious. With the software solution you've announced for EMV chips in the United States, do you have an opportunity to roll out the same software solution across the other markets that already have EMV? And would you do this for free or would you charge for it? Is there some potential revenue upside associated with it?

Charles W. Scharf
Chief Executive Officer & Director

A

No. First of all, on the second one, this isn't about revenue at all. This is about just improving the customer experience.

And remember, around the rest of the world, I'd say two things. EMV is working; it's well accepted. And so we're addressing a very specific concern here as we go through this transition. And then the second thing is, in some of the major markets across the world, there's a very high degree of contactless – that's a card with a chip in it that can be used on a contactless basis, which are very, very fast transactions. And so we continue to promote that as well, and we don't have the issue outside the U.S. that we have in the U.S. as we go through this transition.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Next question, Sam?

Operator: Our next question is from Don Fandetti with Citigroup. Your line is now open.

Donald Fandetti
Citigroup Global Markets, Inc. (Broker)

Q

Yes, Charlie, so you've won two sizable deals with USAA and Costco. I was just curious if there are any other large portfolios or conversions out there that you're looking at.

And then secondarily, it sounds like you're a little upbeat on the U.S. consumer, but the volumes did slow a little bit. Wanted to get your sense there.

Charles W. Scharf
Chief Executive Officer & Director

A

Yeah, so let me on the first one, and I talked about this a little bit. I think when it comes to our position, especially in the U.S., where certainly a lot of these big co-brands are, we love the position that we have. We aren't looking to gain share by being very, very active at targeting or anything like that. Costco is very unique. That was Costco looking, initially thinking about whether or not they wanted to change their issuer and their network. And I've spoken about USAA about how that actually came about. So what we're most focused on in the U.S. is continuing to do a great job and retain the great business that we have on the issuing program side.

Vasant M. Prabhu
Chief Financial Officer & Executive Vice President

A

And on the second part of your question around the U.S. consumer, I think it's important to point out that, I think to perhaps to everybody's surprise, gas prices today are actually lower than the lows reached last year. And in the second quarter, the gas drag was almost as bad as it was last year. It was at least a point on growth in the second quarter. And if it stays at these levels, gas is still a drag on U.S. payment volumes, almost not as bad as last year but quite high. So that's another thing that I guess most people might have expected coming in that you would get to see some kind of a tailwind. It isn't there, but it's anybody's guess though where gas prices go.

Charles W. Scharf
Chief Executive Officer & Director

A

Yes, but I think when you look at relatively stable growth in the U.S. consumer spend plus you talk to the banks about increased savings rates, you just draw the conclusion that the U.S. consumer is in very, very good shape. We can debate about the reasons why spend isn't accelerating, but it certainly I would say feels better than some of the stuff that we've heard. And the fact that savings increased at the right point when there's confidence, we feel pretty good that spend will move to higher levels. So if that happens, if the dollar versus currencies changes and all of a sudden our big cross-border business changes, these are things – back to one of the original questions, these are cyclical things that are out of our control.

So when we look at underlying numbers of transactions and we look at how we're doing on share, the numbers are still very, very strong, and that's what's going to drive the business in the long term once we move in and out of these different cyclical trends that we have.

Vasant M. Prabhu
Chief Financial Officer & Executive Vice President

A

And just one other thing to add, as Charlie said, the underlying transactional trends are very good. And on the margin, even setting aside gas, a stronger dollar is mildly deflationary, as you know, which plays through into payment volumes.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

A

Sam, with that, we have time for one last question.

Operator: And our last question is from George Mihalos with Cowen. Your line is now open.

George Mihalos
Cowen & Co. LLC

Q

Great, thanks for squeezing me in, guys. I guess I'll ask a mobile payments question. And that would be, Charlie, any updated thoughts on the potential longer term to monetize tokenization and maybe bring us up to speed with conversations you're having with issuers about them running their own token vaults? We would appreciate any color there.

Charles W. Scharf
Chief Executive Officer & Director

A

No, we've been very, very consistent that we're not looking to monetize tokenization. Tokenization is a great enabler of different experiences that are out there. We think we're a logical place for the tokenization to take place, but we don't have to be the only place that tokenization is done. So there are some that would like to do more work themselves, create the infrastructure to do that. And we're working with people to ensure that people have that ability. But like most things, we have to compete because we are the right place with the right set of capabilities in a way that they trust more so than other places. And so for us, it's a service, it's an enabler, but not something that we're looking to charge for.

Jack Carsky
Global Head of Investor Relations, Visa, Inc.

And with that, we want to thank everybody for joining today. If you have any follow-up calls, feel free to give Victoria [Hyde-Dunn] or myself a call.

Charles W. Scharf

Chief Executive Officer & Director

Thank you.

Operator: Thank you, speakers, and this does conclude today's conference. Thank you for joining. All parties make disconnect at this time.