Investor Letter for the calendar year: 2021

Author: Timo Buss

Re: How the payments technology company VISA could grow by a factor of 5x by 2030

Dear fellow investors,

Thank you very much for taking the time to read my investor letter for the calendar year 2021. I have been advising the Patient Capital Fund for Hamburg-based fund boutique Covesto Asset Management since January 1st, 2020. **The development of the fund price during the years 2018/19, which you can see on some financial platforms, has to be assigned to the former advisors.**

Once a year I would like to report to you the considerations which were important in advising the fund during the calendar year, whether new significant investments were made, how the portfolio structure and performance at year-end turned out and, at the end, devote myself to one topic in detail.

This year's topic in detail is **how the payments technology company VISA could grow by a factor of 5x by 2030.**

The investor letter begins with a table showing the portfolio structure and a performance overview.

Portfolio structure

NAV* as of 31.12.2021	125.93€
Weight of the largest investment	9.4%
Weight of the five largest investments	37.6%
Weight of the seventeen largest investments	83.6%
Weight of cash	1.9%

*The NAV refers to the I tranche, that was launched on 11.02.2020 at 100.00€

My investment strategy for the Patient Capital Fund focuses on low trading activity with a very high concentration in the best investment ideas. The largest positions in the fund are regularly weighted near the maximum regulatory limit of 10% of the fund volume, the top 5 positions often make up ~40% of the fund volume (2021: 37.6%) and the top 17 positions represent >80% of total assets (2021: 83.6%).

On the next page I would like to inform you about the ten largest holdings of the fund.

Alphabetical listing of the ten largest holdings of Covesto Patient Capital

Alphabet

Amazon

CCL Industries

Fomento Económico Mexicano

Frontier Digital Ventures

Mastercard

Microsoft

S&P Global

Spotify

VISA

The label *NEW* indicates positions among the ten largest holdings that were not part of the portfolio in the previous year (2021: 0). All other movements are due to price changes or additions/reductions of long-term holdings. In case you would like to check upon the holdings more frequently, you can access the portfolio structure which is daily updated here including a breakdown by country, sector and currency

In the past calendar year, I did not recommend a new company to be included in the top 10. All of the fund's ten largest holdings were already part of the portfolio in the previous year and movements are primarily due to price changes.

Performance overview

Period	Covesto Patient Capital* (1)	DAX** (2)	Delta (1)-(2)
2020	10.2%	3.6%	+6.7%
2021	22.4%	15.8%	+6.6%
cumulative since 2020	34.9%	19.9%	+15.0%

*The performance relates to the S tranche in 2020 only and to the I tranche from 2021 onwards (launch date: 11.02.2020)

**The fund is not limited to German companies. I am therefore of the opinion that a tabular comparison with the domestic DAX index is only partially meaningful. A comparison with so-called world indices (in EUR), for which the renowned index providers regularly charge high fees, would be more substantiated in terms of informative value

The table shows the performance of the fund since I started advising it. In my Investor Letter for the 2020 calendar year I explain why such a table provides little information about the skills of a fund advisor in the short run. Only in the long run will it become clear whether a fund advisor creates repeatable value-add for his investors with a previously defined strategy. After showing the fund performance in the table above, I don’t intend to address it too much and instead have a more detailed interim result discussion in January 2025 (after five full calendar years of performance). **My goal remains to achieve a performance of >10% p. a. on average for your as well as my investment in the fund over the long run.**

<u>How the payments technology company VISA could grow by a factor of 5x by 2030</u>

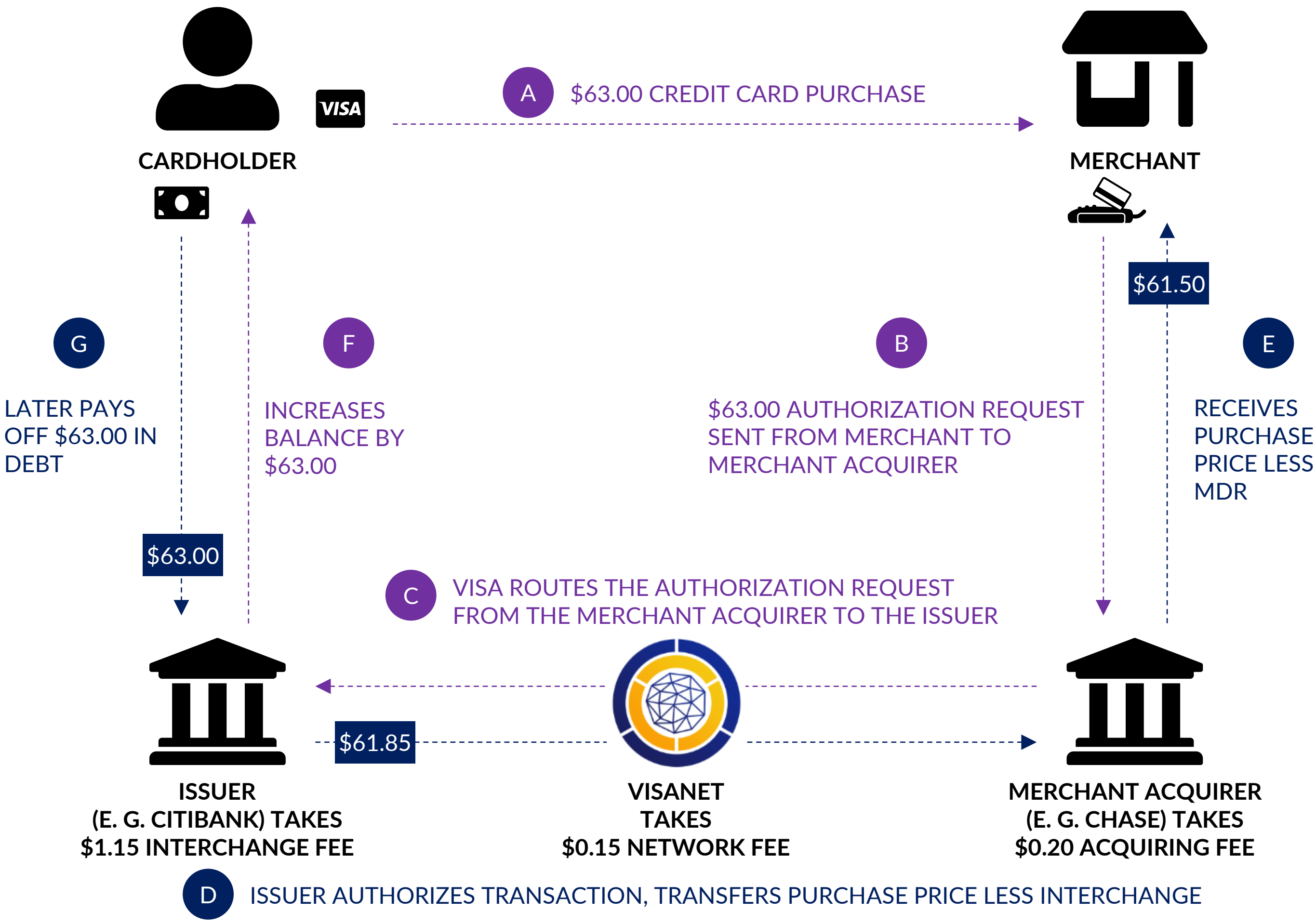
To achieve a performance of >10% p. a., the largest holding of the Covesto Patient Capital fund, the payments technology company VISA (2021: 9.4% of NAV), is expected to make a significant contribution. Outside of China, **VISA operates the largest credit and debit card network in the world with a market share of 60% and a lead of 1.8x over its closest rival Mastercard**. There are 3.7 billion VISA cards in circulation worldwide making them the most accepted payment method on the planet, which can be used at 80+ million merchants. VisaNet is the heart of the payments technology company based in San Francisco and enables authorization requests and clearing and settlement between a cardholder's bank (issuer) and a merchant's commercial bank (merchant acquirer). More than 15,000 participating banks use VisaNet to conduct transactions with one another without the need for bilateral contracts.

VisaNet was originally introduced by Bank of America as a closed loop system under the brand "BankAmericard" and has built up strong network effects since it was opened to third-party banks more than 60 years ago. On one side of the network there are consumers who ask for a VISA card from their bank because, unlike national debit cards (e.g. Girocard in Germany), they can use it internationally to pay at most retailers. If you were only allowed to take a single means of payment with you on a trip around the world, the VISA card would certainly win the race. On the other side of the network, more and more merchants are accepting VISA cards, as over 1 billion people prefer to pay with them and sometimes even no longer carry cash as an alternative. Payment networks which are trying to enter brick-and-mortar retail, and start without network effects built up over decades, are regularly destined to fail, as their retailer and consumer penetration cannot reach an efficient scale compared to the market leader. VISA as the leading network processed 165 billion transactions in the past fiscal year (>5,000 transactions per second) with a payment volume of $10.4 tn (Ø-receipt: $63), a net revenue yield of 0.23% (based on net revenues of $24.1 bn) and an operating margin of 66% (EBIT of $16.0 bn). The company has an outstanding track record in expanding the card business and has increased its payments volume by more than a factor of 10x every 20 years (1975: $0.01 tn, 1995: $0.60 tn, 2021: $10.4 tn).

The anatomy of a card payment

14 cents – that is the calculated amount VISA earns on each transaction with a VISA card (0.23% of the payment volume with an average receipt of $63). **What at first sounds paltry, results in one of the world's most profitable and attractive business models due to the vast number of transactions and high operating leverage**. VISA guarantees merchants that they will receive the sales price for authorized credit card transactions, unlike ACH payments or traditional purchases on account. VISA gets renumerated handsomely for the merchant's added value in terms of security and for the cardholder's added value in terms of convenience (e.g. through its pioneering role in introducing contactless payments or reward programs). Some readers might already have noticed that in practice the merchant fee is noticeably higher than the previously mentioned 0.23%. Your remark is correct since, in addition to VISA, other financial institutions are involved in the payment process and get remunerated for their role as well (in particular the card-issuing bank which bears the credit risk). If you take into

account all parties involved in a VISA transaction, the Merchant Discount Rate (or in short: MDR) for credit card payments usually adds up to 1.5-3.0%.[1] I try to explain the anatomy of a card payment and which financial institution earns money at what stage with the help of my following, overly simplified visualization. Depicted here is a purchase with a VISA credit card over $63 with an MDR of 2.4% and an interchange fee of 1.8%.



In addition to VISA, four other parties are involved in the transaction shown above, which is why it‘s often called the four-party model:

1) the cardholder who purchases a product from the retailer
2) The cardholder's bank (issuer) who bears the credit risk and receives the interchange fee
3) the merchant who hands over the goods and receives the purchase price less the MDR
4) as well as the merchant's commercial bank (merchant acquirer), which receives an acquiring fee

Using the letters A-G, I have identified process steps showing that VISA's primary task is communication between the cardholder's bank (issuer) and the seller's bank (merchant acquirer). VISA

[1] The MDR for debit transactions is markedly lower since interchange fees are capped at 0.2-0.5% depending on the region

sends authorization requests from the merchant to the issuer for >5,000 transactions per second, usually sends the response back in less than a second and carries out a net settlement for all successful transactions each day (and is therefore entitled to credit and debit special accounts at over 15,000 financial institutions). The 0.23% of the payment volume that VISA collects is primarily for routing authorization requests, fraud detection and clearing and settlement. Compared to the overall MDR for card payments of 1.5-3.0%, it is obvious that VISA only claims a small portion of the added value and that there are sections within the payment process that are more profitable percentagewise. Companies entering the market regularly attack the latter, while the network and infrastructure services provided by VISA are often accepted as given. **I observe almost without exception that successful start-ups prefer to build their business models on top of VISA's existing network instead of entering into direct competition with a massive disadvantage in scale**. A good example of a former payment start-up that preferred to build its business model on top of the existing networks instead of going to war with them is *PayPal*.

The PayPal files: Friend or foe?

Max Levchin, co-founder of PayPal and today's CEO of Klarna challenger Affirm, once said the following during a speech at Stanford University:

*"**PayPal is actually a, more or less, commodity business. It sounds very cool and innovative e-mailing money around and moving money in the internet but it's really not very difficult.** The credit card interface has existed for 20 years. The AFT system existed since the '70s which is the way you move money into bank accounts. It's really not that tough. All we really do is to put a very pretty web front-end on it and let people use their e-mail address instead of their account number."*

Levchin was spot on with this statement concerning what made PayPal successful in its early days, namely industry-leading convenience for online shoppers and an unmatched low checkout abandonment rate for merchants. PayPal substituted the entry of credit card information (16-digit card number, expiration date, verification number) for a combination of e-mail and password that is easier to remember. Today PayPal processes a payment volume of >$1 tn annually, has leading expertise in risk management and fraud detection, continues to offer merchants unmatched low checkout abandonment rates in the range of 10% and has ambitions to advance from mobile wallet to super app. So far, however, the monetization of the payment service provider is essentially not very innovative and builds on existing networks, as Max Levchin himself adds below.

„So the underlying business model of PayPal is actually that of a security company, a risk management company, that provides an extremely important yet commodity business on top. And the toll-bridge model which PayPal turned to in August 2000, namely every time someone sends you a little bit of money, we just take a slight bit off the top, is really not very novel either. It's how Western Union works. It's how a lot of other transactional processors work all over the world."

PayPal uses the reach of existing card and banking networks that have been built up over decades and adds its own fee on top of the networks' infrastructure costs. **Since August 2021, PayPal has been charging 49 cents plus ~3% of the transaction volume for commercial transactions and remits ~40% of this take rate to the long-established players in the processing chain**. This business model is extremely lucrative and has enabled PayPal to achieve a market value of more than $200 bn recently. The take rate of ~3% applies regardless of whether the customers have linked their credit card (higher transaction costs) or their bank account (lower transaction costs) to PayPal. Around half of all PayPal transactions are made on card rails from VISA, Mastercard or American Express, and the other half on bank networks like ACH. A disintermediation of VISA would increase the transaction margin by leaps and bounds. Around 2016 PayPal therefore experimented with whether such a disintermediation was possible, but quickly had to surrender to VISAs integration into the global payment landscape. Too many parties benefit from the status quo of higher card fees compared to direct A2A payments, so that PayPal could not force changes here. The cardholder benefits from cashback or reward programs, the issuer from interchange fees. Since VISA represents, depending on the region, up to 25% of PayPal's business volume, compared to PayPal only <5% of VISA's payment volume, PayPal's CEO Dan Schulman quickly opted for a multi-year partnership with VISA instead of an ongoing confrontation. The same applies to mobile wallet providers like Android Pay, Apple Pay and the recently hotly debated Buy-Now-Pay-Later companies (BNPL) Klarna and Affirm. I believe it is absolutely telling that for brick and mortar retail – which is four times as large as online retail at 20% global e-commerce share – each of the aforementioned companies developed an own credit card in partnership with the leading card networks.[2] The Apple Card is not based on VISA but on the Mastercard network, but if one wants to underwrite the thesis of an ongoing disruption of the long-established financial service providers, one must be able to answer the following question: ***„If not even Apple, as the richest and most valuable technology company in the world, plans to disintermediate the networks in the highly regulated financial sector and instead prefers to build products on top of them, who else will?"***

If everything is going so well for VISA, why not its share price?

A disintermediation of the card networks by Big Tech portrayed in some media outlets doesn't appear to be near. In reality, payment solutions such as Apple Pay or PayPal are strengthening VISA's business model by accelerating the shift from cash to digital payments. For the network operator, additional transactions hardly lead to incremental costs, which is why VISA's growth rates should in theory look as follows: earnings per share > revenue ≥ payments volume. This pattern was broken, however, in 2020 with a revenue development < payment volume. Since then, the share price has also lagged the American benchmark index S&P 500 (see table on the next page).

[2] Please refer to e. g. the Klarna Card, Afterpay Card, Apple Card, Affirm Card or Upgrade Card

VISA: yoy-growth	2018	2019	2020	2021	2021 vs. 2019
Payments Volume	+12.2%	+6.0%	+0.0%	+18.3%	+18.3%
Net revenue	+12.3%	+11.5%	(4.9%)	+10.3%	+4.9%
Earnings per Share	+31.6%	+17.9%	(6.7%)	+17.3%	+9.4%
VISA Total Return	+16.5%	+43.3%	+17.1%	(0.3%)	+16.8%
S&P 500 Total Return	(4.4%)	+31.5%	+18.4%	+28.7%	+52.4%

Where does this poor performance stem from? In my opinion, from the travel restrictions in the wake of the COVID-19 pandemic which are burdening the travel industry but should be withdrawn in the long run. Before the crisis, VISA generated 27% of net revenue from cross-border transactions, where the card-issuing bank and the merchant's commercial bank are located in different countries. Due to additional fees and FX margins, these transactions are *highly profitable* for VISA, but are currently idle. Historically, 2/3 of cross-border volumes came from travel-related consumer expenditures and 1/3 from cross-border e-commerce. The latter is increasing while the travel business suffers. Frankfurt Airport, a hub for international flights, symbolically reported a decrease in passengers in 2021 of 66% below the 2019 levels and VISA reported a decrease in its travel-related cross-border revenues by 50% vs. 2019. **Outside the travel industry, however, the structural growth of digital payments is unbroken, which is why the total payments volume of $10.4 tn processed by VISA is already +18% above the pre-crisis level (2019: $8.8 tn).**

The COVID-19 pandemic has two different consequences for VISA: a temporarily negative one (travel restrictions) and a permanently positive one (more card payments in everyday life). While people are reducing their travel expenses and relocating them domestically (temporarily negative), they have discovered contactless payments in everyday life for the sake of hygiene and speed (permanently positive). Since the beginning of the pandemic, even the smallest amounts can be paid by card almost everywhere and in Australia 90% of all VISA face-to-face transactions are already made contactless. As the world's largest consumer spending market, the U.S. is lagging and has only recently established the requirements for widespread acceptance of contactless payments.

After the introduction of “tap-to-pay” in Australia, it took ~24 months until 10% of all card payments in brick-and-mortar retail were made contactless. After that, penetration skyrocketed. The average cardholder made twice as many VISA transactions in supermarkets and increased his card payment volume by +15%. In the U.S., “tap-to-pay” penetration has risen from 5% to 15% because of the pandemic – urban cities such as New York or San Francisco are already at higher levels (30-35%). **In my opinion, the country is on the verge of a contactless payment breakthrough.** This could accelerate the revenue dynamics in VISA’s home market, which is an important driver for the company at ~50% share. With an additional reduction in travel restrictions, the core business could generate earnings of ~$10 per share in 2024, which would correspond to an upside of 30% solely based on historic forward multiples. However, VISA could possess a much larger upside if the company can continue the already successfully taken course in business-to-business payments (B2B) and establish a second operating pillar in addition to its traditional card business between consumers and merchants (C2B).

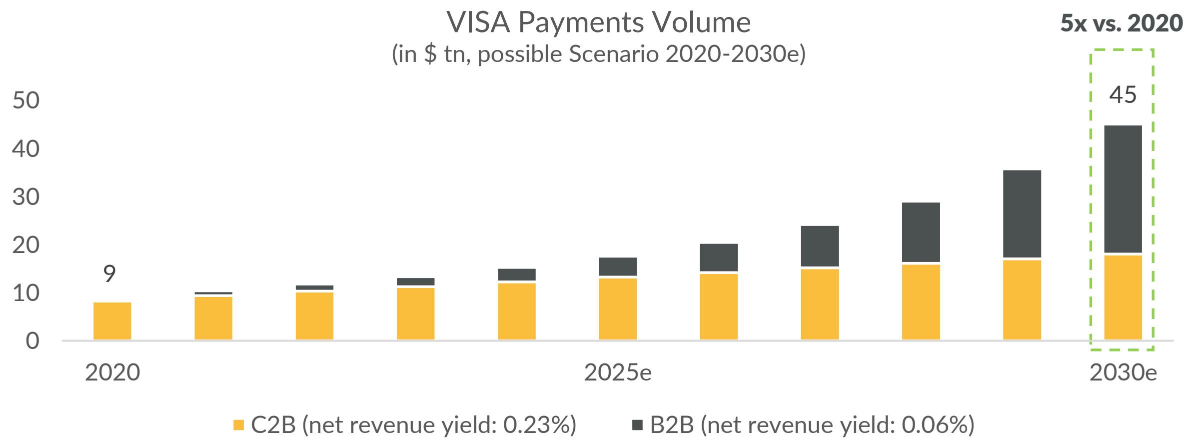
The 5x opportunity for VISA in B2B payments

Before I quantify the potential in B2B payments, I would like to emphasize that the traditional C2B business still offers attractive growth opportunities for many years to come. The C2B business generates a royalty on the sum of global consumer spending, leveraged by share gains of digital payments and with built-in inflation protection. **One of my core beliefs is that an (indirect) investment in the trajectory of global consumer spending is one of the most convincing "bets" one could make on the future of our world**. In the following I would like to provide some context why I see it this way.

You might be reading this investor letter right now on an iPhone or a MacBook. Solely because of this you probably belong, like me, to a total of ~1 billion privileged people in the world who can already satisfy many of their consumer needs. On the income scale of 1-4 according to the Swedish Gapminder Foundation (1: less than $2/day, 2: $2-8/day, 3: $8-32/day, 4:>$32/day), we belong to level 4 (>$960 income per month). At level 4, the potential for our consumer spending to increase may no longer seem particularly great because, after all, we already have access to clean drinking water everywhere, get affordable electricity, can afford processed foods in the supermarket, some of us own a car in addition to a bicycle, we fly on vacation abroad, live in centrally heated apartments with functioning door locks, can use a microwave, toaster or oven in the kitchen and set a comfortable water temperature between cold and warm water when we shower in the morning.

However, the sum of all these amenities currently does *not* apply to almost 7 billion people (>80% of the world population) who so far can only dream of a new bicycle, electronic kitchen appliances, a long-distance flight, high-quality mattresses, a computer, regular restaurant visits, designer clothing, better health care, an own apartment or even their own house. The potential to increase consumer spending for people at levels 1-3 is *gigantic* and will be realized over many decades to come.

Despite this tailwind, VISA will at some point no longer be able to grow at the same percentage rates as in the past due to base effects in its C2B business. However, to create greater value for shareholders, VISA's management can address a 4x(!) bigger market in business-to-business payments (B2B, $125 tn), salary payments (B2C, $30 tn), remittances (P2P, $20 tn) and government benefits (G2C, $10 tn). In contrast to C2B, VISA's penetration rate in B2B is below 1% and the market is not yet clearly taken. To date, half of all B2B payments in the U.S. are still made through bank checks, which are more inefficient and more prone to fraud than digital payments. VISA has massively expanded the capabilities of its network over the past few years to offer new solutions in B2B, B2C, P2P and G2C. **In B2C, drivers for the food delivery service DoorDash or the ride-hailing service Uber may access their wages in real time via VISA Direct instead of waiting for weekly employer transfers.** VISA B2B Connect enables faster B2B cross-border payments with more predictability and transparency. Some of these new products show growth rates of >50% and could become a second mainstay for VISA by the end of the decade. In 2030, B2B could contribute ~30% to VISA's potential total revenue of $64 bn versus <10% today. High margins of >80% on incremental transactions could lead to a disproportionate increase in profits to $38 bn (factor 3x compared to 2021). Along the way, the company should also generate half of its current market capitalization of $460 bn as excess liquidity. Even with a contracting multiple to the low 20s compared to historically 29x net profit (e.g. in an environment of rising interest rates), exceeding the target return of >10% p. a. seems imaginable. By entering the B2B area, VISA could grow by a factor of 5x in the long term instead of "only" by a factor of 2x in its core business (see figure).



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The bottom line is the following: The opportunities just described make VISA an interesting holding for the Covesto Patient Capital fund. As with all promising investment opportunities, there are numerous risk factors that need to be monitored. There is a short-term, limited risk related to the DOJ's antitrust investigations. A longer-term, potentially more far-reaching risk lies in the evolution of blockchain-based payment systems, which are currently struggling with anti-network effects and efficiency disadvantages. **My job as a fund advisor is not total risk avoidance – which would inevitably lead to total return avoidance – but rather to weigh and take reasonable risks at favorable prices**. In relation to the risk taken, VISA could prove to be an attractive investment for us over time.

January 10, 2022

More Informationen on: www.patient-capital.de/fonds Subscribe here: www.patient-capital.de/newsletter

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