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Extra Credit for Visa's IPO

Mar 10, 2008 4:37:00 AM

Financial markets face a key test on Mar. 20, when Visa Inc. plans to float the largest initial public offering in U.S. history. The Visa debut could bring in up to \$18.8 billion, a flood of investor dollars in the midst of what is otherwise one of the driest IPO markets in recent years. The deal's underwriters, which include Goldman Sachs (GS) and JPMorgan (JPM), will try to attract investors by pointing to Visa's solid spot atop a fast-growing industry. As customers around the world shift from cash and checks to credit and debit cards, the benefit accrues to Visa and smaller rivals like MasterCard (MA), American Express (AXP), and Discover Financial (DFS). Visa's revenues grew 33% last year, to \$5.2 billion, and the Nilson Report estimates the number of card transactions globally should grow 11% each year through 2012. As fears of a U.S. recession rise, Visa can market its stock as a haven. Not only is much of its growth expected to happen overseas your Visa card can be used in 170 countries but it's a 'relatively recession-proof business,' says Gwenn Bzard, research director with the Aite Group. Visa doesn't issue the pieces of plastic that bear its name to consumers or mail out their bills. That is left to banks that issue the cards. Rather, Visa runs the credit-card network that connects the banks and merchants. It makes money on each transaction made over its network, so it's somewhat sensitive to the ebb and flow of consumer spending. But it doesn't assume any of the risk that cardholders won't pay their bills, which is a rising risk in a recession. Putting together an \$18.8 billion IPO is a huge undertaking, especially at a time of market turmoil and economic uncertainty. The deal has 19 underwriters, which is more than Scott Sweet of IPO Boutique says he has seen in his 35 years watching IPOs. The investment banks 'desperately want this deal to go well,' Sweet says, because it could generate \$500 million in fees. With the financial sector walloped by the subprime crisis, 'they need this revenue,' he says. Some aspects of the Visa deal could give investors pause. The card network and brand name are well-established, but the company is the result of a reorganization completed in late 2007. The management team is brand new. But the biggest risk to Visa may be a series of lawsuits and government regulations, some a decade old and some still in the works, aimed at introducing more competition to the industry. Regulators, rivals, merchants, and banks have claimed Visa unfairly dominates the credit-card network. As part of the IPO, \$3 billion will be set aside to pay out settlements, but Visa surely will face more costly court fights and a more cutthroat marketplace. 'There's a tremendous potential here that the profitability of Visa and MasterCard could be seriously damaged by regulation,' says Tom Mangan, portfolio manager of the James Advantage funds. If, despite the risks and the tough economy, the Visa IPO is a success, it will represent a rare sign of health for the financial markets. Sweet says the Visa deal could bring an 'avalanche of interest' in the IPO market, which has been in the doldrums since the New Year. 'That they can assemble a deal of that size, in this market environment, is both intriguing and exciting,' he says. Goldman and JPMorgan are hoping to repeat the success of MasterCard's 2006 IPO shares more than tripled in the first year. But they want to avoid the fate of the Blackstone Group's (BX) initial offering. Shares of the private-equity firm have plunged 58% since its June, 2007, debut. If Visa goes the way of Blackstone, the anemic IPO market could get even weaker. Both the number and size of global and U.S. IPOs so far in 2008 are at half the level they were at this point in 2007, according to Dealogic. IPOs by large, well-established companies like Visa are rare. A more typical IPO is a small, young company that needs capital to keep growing. And it has been harder for those firms to get IPO capital. Last year, software maker VMware (VMW) went public and jumped 73% in its first two months. Times have changed: Biotech company Bioheart (BHRT) has fallen 5.7% since its February IPO, despite what Sweet calls a 'fire-sale price.' Investors, worried about the economy and their shrinking portfolios, simply aren't willing to take a chance on new, speculative stocks. By going public now, Visa is taking a chance. Shares are expected to be priced at \$37 to \$42, for a total take of \$15 billion to \$18.8 billion. The final price will be set on Mar. 19, and the stock will start trading the following day. 'The price is not what they could have gotten in a stronger market,' says Nick Einhorn, an analyst at Renaissance Capital. So why do an IPO now? For one thing, the IPO is part of a long process of reorganizing the company, combining various loosely affiliated Visa companies around the world. That's a long two-year process that's hard to put on pause, Einhorn says. Plus, Visa's owners are the banks who issue Visa credit cards. With financial firms posting huge losses, these banks definitely

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need the money the IPO is expected to generate. Also, Mangan says, the IPO gives Visa's owners a chance to unload some of the company's liability risk. Visa is promising that its former bank owners, not new investors, will assume much of the risk from lawsuits. But it will be a while before investors see how the regulatory and liability issues are worked out. As with any new company, it will take some time for Visa to prove itself. The market will watch carefully to see how Visa is handling competition and global growth. The Aite Group's Bzard notes that Visa is spending big on incentives for merchants and banks that issue its cards, and he wonders how that spending will affect profits in future quarters. Also, Visa faces a lot of local competition around the world; China, for example, has set up its own credit-card network. 'There are lots of opportunities, but it's not going to be a walk in the park,' Bzard says. Even MasterCard's IPO didn't do amazingly well right away. It took a few earnings reports before investors were convinced of the company's potential, Einhorn says. Visa's IPO will be an important test of strength for financial markets that have looked pretty wimpy lately. But Visa's real challenge will be living up to investor expectations in the years to come. Check out the BusinessWeek.com slide show to see the . A strong response to the credit-card titan's public offeringthe biggest ever in the U.S.could thaw out the freeze in new offerings

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