FIS

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Ramsey El-Assal: We are pleased to welcome Erik Hoag, CFO of FIS with us today. Erik, thanks so much for being here. Appreciate it.

Erik Hoag: Hey, Ramsey. Good morning. Thank you for having me.

Ramsey El-Assal: Can you give us a little, to kick it off here, give us a little view of sort of what you're seeing in trends, transaction trends, most recently in your book. Or any -- maybe let that bleed into some commentary about the overall macro environment you're seeing out there.

Erik Hoag: Yeah, sure. Maybe if I were to even take a step back to the start of the year, on the acquiring side, we saw strong growth in January and February. It moderated a little bit during the month of March. April, very consistent with March. And year-to-date, May is very consistent to the month of April. On the FIS side, global volume was 9% in the first quarter as well. Really strong start to the year.

Ramsey El-Assal: Fantastic. I wanted to drill down a little bit into that 9% volume growth in Merchant in the quarter which was an impressive result. Disaggregate that a little bit in terms of the drivers. What's working in Merchant? What is there -- what isn't? Help us think through how you achieved that solid result.

Erik Hoag: What's working in Merchant? Great question. In the first quarter, our Merchant business grew roughly 2%. If you break it down, the real bright spot in Merchant during the first quarter for FIS was our ecommerce business. We had 15% organic growth, new growth in the first quarter. 18% growth if you exclude the impact of Russia and Ukraine. Our global ecommerce business is performing well. It's grown double digits for the last several years. We guided 2023 to double digits as well.

Underlying drivers to growth in ecommerce, we've got differentiated authorization rates. We help enable our customers drive their own P&Ls I'd say first and foremost. Number two, global reach. Our global e-com business truly is global. And the one thing that FIS really did bring to the table associated with the FIS Worldpay acquisition was the global scale that FIS was able to help enable. Where the Banking business, the Capital Markets business, they operated in so many geographies, that we were able to quickly standup and integrate out global ecommerce business into some additional geographies. Incremental geographies, differentiated authorization rates.

And then in December of 2021, our ecommerce business, we acquired a company called Payrix. Performed very well in '22, performing very well in 2023 as well. The ecommerce book, which is roughly 30% of the Merchant portfolio at FIS. We've got an enterprise book which is roughly 45% of the revenue within the segment. Think big box. Big box retail, grocery, pharmacy. This business in a steady state environment should bump around at GDP. We're priced per transaction in the enterprise book. The business is performing well. Obviously, there's some macro factors here. The UK sits in our enterprise book as well.

And then the SMB book, which is roughly 25% of the portfolio. E-comm 30%, enterprise 45%, SMB 25%. We've got some structural challenges here. When we guided 2023 for the SMB book, we included roughly 300 basis points of headwind associated with some product gaps. We had a good first quarter. We outperformed that a bit. But one of the underlying catalysts for the spin of the Worldpay business was to help enable getting incremental product into the SMB book through organic investment and strategic M&A.

Ramsey El-Assal: In the SMB book, or in the SMB business, what parts of the value proposition are you lacking? What is it sort of more precisely that SMBs might be looking for now that you -- what's that gap you need to fill in order to --

Erik Hoag: Good question. Probably no surprise to anybody here, but COVID changed the acquiring landscape rather dramatically. The SMB book has historically been a card present channel. As COVID came through, and then there was more curbside pickups or more order ahead needs, it really disenfranchised the SMB book that we had. What we have done, the Payrix acquisition in December of '19 provides card not present capabilities down into the SMB subsegment, which is helping to address some of those gaps.

Ramsey El-Assal: You already answered a significant part of this question, but maybe not fully. In terms of e-comm, the value proposition there that's allowing you to win, you mentioned authorization rates. What is it there that -- how do you differentiate yourself kind of from a competitive standpoint? And globally, there's a couple of big high-profile competitors. What's allowing you to win there? Is it just pure performance on the transaction or is there a technology overlay? Tell me more about that business.

Erik Hoag: I would really say -- I would really come back and talk about just those 2 things I mentioned before. The global reach that it provides, that we can follow customers. As customers want to expand their own geographies, we're enabled in many of those geographies that they want to expand into.

And then the second piece really is the authorization rates. It's really all about enabling our customers, trying to drive more throughput for our customers, and ensuring that they're capturing as many transactions as they can.

Ramsey El-Assal: One thing that investors focus on, for better or worse, the spread between volumes and revenue. Speak to the drivers of that delta and whether we should expect that to sort of widen before it tightens or how we should think about that as we move forward?

Erik Hoag: Sure. The Merchant business for FIS had a yield of minus 7 in the first quarter, organic revenue growth at 2. Global volume growth of 9, so a yield of minus 7. I'd say maybe a couple of things about yield in the first quarter. Number one, the consumer was strong. We saw a lot of revenue that came through. A lot of volume that came through, excuse me. A lot of volume that came through our enterprise channel. Think about I mentioned nondiscretionary spend. Nondiscretionary spend where we price per transaction, so volume less revenue. We also have a headwind associated with Russia Ukraine. A very rich -- the e-comm book, very rich yields. A headwind in the first quarter associated with Russia and Ukraine. As we move through the cadence of the year, I would expect our yields to narrow.

Ramsey El-Assal: Just due to those factors, sort of anniversary of Russia, that sort of thing?

Erik Hoag: Anniversary of Russia. We've got the UK as well as we start to normalize off the UK from last year as well. I think those are 2 predominant drivers associated with yields.

Ramsey El-Assal: And one last question on the Merchant, UK is another place where you guys are doing business. There's obviously a lot of macro headwinds there. Give us just a little bit of an update on the UK Merchant business.

Erik Hoag: Not a whole lot of change associated with the UK Merchant business quarter-over-quarter. Fourth quarter to the first quarter, as we head into the second quarter, the good thing, as I just mentioned, is yields will moderate a little bit. They'll provide us a little bit more comfort associated with revenue and volume.

Ramsey El-Assal: Are you seeing a little more macro stability in the UK or is it hard to pin down?

Erik Hoag: I would say that moving into the second quarter from the first quarter, there hasn't been much change.

Ramsey El-Assal: Not much change, okay. On Banking and Capital Markets, I've been covering this company for quite some time and I remember in the old days on the earnings calls, you would often hear a lot of questions about the bank IT spending environment. On the other hand, there's kind of an understanding that some of these businesses are pretty defensive and resilient when it comes to the cycle, the economic cycle. I guess the question is, with that preface, bank IT spending environment, first, that's kind of a tactical question. What are you seeing out there? And second is, how important is that? Do you guys really see those budgets tighten and loosen? Does that have a big impact on the kind of keeps your lights on type services that you guys are providing? Two questions in there.

Erik Hoag: No, good questions. The bank IT spend, I would say that there hasn't been any change quarter-over-quarter particularly coming out of I'd hate to call it a bank crisis in the month of March, but sort of the volatility with regional banks in the month of March. From a sales perspective, I might even step all the way back and say in the middle of 2022, we changed our sales construct to be a little bit more quality focused as opposed to quantity focused from a sales perspective. We're focusing back on core IT spend, mission critical software associated with the core. Ledgering systems associated with Banking side. Ledgering systems associated with the Capital Markets side. And what that has done is, what that will do is drive higher incremental contribution margins. It refocused back to what you're probably familiar with over the years which is core sales, the ancillaries that come surrounding the core sales, higher contribution margins, and to your specific question, associated with IT spend. We haven't seen much change.

Ramsey El-Assal: Hmm, interesting. I'd like to drill down a little bit on the shift in strategy in terms of the sales strategy. I think you called out sort of pursuing more sort of high profit deals. Unpack that a little bit for us. You just mentioned emphasizing kind of core products. Is there -- does this mean more profitable products? Are their contracts structured differently? What exactly is shifting in terms of what you're pursuing, what you were going after then versus now.?

Erik Hoag: Yeah. Over the last several years, Ramsey, if we go back to 2019, one of the -- on the back side of the Worldpay acquisition, we had talked about fit to growth. And we are being rewarded for growth. Between '20 and 2021, there was really a shift towards the quantum of sales transactions, volume of TCB driving growth. What we found is that some of those solutions that we were selling just had lower contribution margins. Lower contribution margin which forces us to do other things in the other parts of the organization to drive, to try to drive enterprise-wide operating margins.

What we've done in the back half of 2022 and what we've done here in the first part of 2023 is recalibrate the sales organization, recalibrate our commissioning structure, recalibrating our quota allocation processes to focus more on longer term SaaS driven product sales. The longer-term SaaS driven, long contracts, wide competitive moats where we can drive higher incremental contribution margins. Helping drive total company operating margins.

As opposed to what we had been doing which was, and you're seeing in our financials today, which is there had been growth, but also dilutive in nature as well. We're trying to get back to the roots of what FIS was which was software led sales, high incremental contribution margins, high levels of cash generation, which all ultimately drives shareholder return.

Ramsey El-Assal: And how difficult is the process to make that transition? Which I guess is another way of asking, is there sort of an air pocket as you pivot to these new deals, start new sales cycles, get those to fruition? There's a little bit of a gap there. How should we think about -- or maybe that's not the case. How should we think about that in terms of magnitude and duration?

Erik Hoag: As I think about the Banking business from an almost if I were to step back and talk about the growth algorithm itself, there's an organic element of the Banking business where we've got same store sales growth, number of deposit accounts that are at a financial institution. Number of transactions that are running across our NYCE network. We have got net new sales, so we've got the sales element that you're talking about. There is a conversion underway to move from lower contribution margin to higher contribution margin. But there's also energy being put associated with the attrition stack. If you think about same store sales, organic growth, net sales which is new sales minus customer attrition, and then net pricing, there's an opportunity for us to ensure that we're getting the most out of our price offsetting with compression as well. There's a couple of ingredients to the growth algorithm. Sales is one of them, but it's not the only one.

Ramsey El-Assal: Interesting. Capital Markets from my perspective is always probably the least well understood segment in terms of investors. Give us, help us think through sort of what the growth algorithm is in Capital Markets. What should we be thinking about as driving growth there?

Erik Hoag: The Banking and Capital Markets businesses are becoming more and more similar every day. When we acquired the SunGard business in 2015, this was a licensed based organization. Today, it is a SaaS driven organization. And it's not product sales, it's solution bundles as well, longer term contracts, price escalators, very sticky product sales. Over the last several years, we've held license revenue flat. The growth that we're seeing in Capital Markets is all recurring in nature. It's high incremental contribution margins. This is a business with very rich operating margins. They are leaning heavily into a focus around high incremental contribution margin sales and the predominant growth algorithm is just that. It's more recurring, less onetime revenue, and we'll continue to wean off that license dependency over the next several years.

Recurring revenue in Capital Markets is roughly 72% or 73%. In Banking, it's 83% or 84%. We've got a little bit of runway until the business, until it catches up with the Banking business. But we feel great about what's going on in the Capital Markets business. Performance has been very strong over the last several years and I'm excited about what it can continue to become.

Ramsey El-Assal: Are there any external exogenous factors that drive that business? If we see periods of extreme market volatility or increased any type of external activity, is there any correlation in terms of whether it could be a tailwind or headwind for the business? Or is it sort of more, again, like the rest of your businesses, kind of keep your lights on, steady state, license receipt type of thing?

Erik Hoag: Ramsey, we are moving more towards the Banking-like environment. In the first quarter, admittedly, a little bit of -- a couple of stats on the Capital Markets business for those of you who might not follow the story. 7% organic revenue in the first quarter, recurring revenue growth in the first quarter was 11%. The 11%, to your point, slightly overstated because we had some market volatility in the month of March associated with what was going on in the banking macro. But more and more, it is recurring in nature and less volatility associated with trading or other drivers like AUA or AUM.

Ramsey El-Assal: I meant to ask this one earlier. In terms of the overall turmoil in the banking system, it's evident that it didn't have any kind of acute impact on the business. Is there any longer duration kind of impacts folks should be thinking about? Maybe bank consolidation or other types of impacts that may or may not materialize from the banking crisis? Or is it a nonevent as far as you're concerned?

Erik Hoag: Yeah, maybe a little bit of background for those in the room on the Banking business and who we serve. FIS really tailors upmarket towards larger financial institutions. As banking consolidation occurs, we believe that we're benefactors there because it's the larger regionals that should be the acquirors, be acquirees. We think we're positioned very nicely associated with the FI market itself.

And then very specifically, during the month of March, we saw an increase in new account openings. New deposit account openings. As customers were trying to get under the FDIC limits, we saw new account openings. And once the new account is opened, you see all the ancillaries. You have the new deposit account, and then you've got the debit card, the credit card, the prepaid card, the NYCE network, and the other ancillaries to come with opening a new account. We saw an acceleration in the month of March. The Banking business outperformed our guide in the first quarter in part due to incremental accounts on the Banking side during that tail end of the quarter.

Ramsey El-Assal: And you're not really indexed to kind of deposit flows at the end of the day, those sort of maybe savings account type flows is not really something that is, that people need to keep an eye on. There's just the narrative of deposits leaving sort of small and regional banks and going to sort of larger banks. Now you guys index a little higher than some of your competitors in terms of the asset size of institutions, so maybe that's a bit --

Erik Hoag: We do index a little bit higher, but the predominant driver for us for revenue is the number of accounts, not the value of the deposit.

Ramsey El-Assal: Right, okay. I want to move onto the proposed Merchant spin. Maybe take a step back and again help us think through the rationale of that decision to basically tie off that business.

Erik Hoag: Sure. Merchant has been almost -- I'm going to bring our conversation back to the SMB discussion that we had a little bit ago. In the 2023 guide, we included roughly 300 basis points of Merchant headwind associated with product gaps. For it to really thrive, it needs to be fed with some incremental products injections, whether it's organic investments or strategic M&A. The spin rationale is really dependent upon capital structures of both organizations. Worldpay, think high yield. Think more M&A. On the remain co side, think compounder, investment grade, lower leverage levels. Capital allocation philosophy is really associated with growing our dividend, share repurchase, potentially some tuck-in M&A. But the predominant driver here, Ramsey, is unlocking Merchant to be able to go out and drive incremental product into their portfolio.

Ramsey El-Assal: How should we think through the sort of distribution of debt or leverage in terms of the remain co and the spin co? One question I often get is, if the spin co comes out with some leverage on it, will that make it more difficult to execute on the strategy?

Erik Hoag: Working through it right now. I would hope that with our second quarter call we're able to talk more fulsomely about dis-synergies as well, and leverage levels. But broadly speaking, when I think about the 2 companies, it's back to the comments that I just made which is Worldpay, high yield, higher leverage, more focused on product investment, either organic or inorganic. And then on the remain co side, lower leverage, investment grade, different capital allocation philosophy.

Ramsey El-Assal: Okay. You mentioned dis-synergies. I know that you guys have called out things like commercial agreements to manage your revenue dis-synergies. Is that relatively simple? Do you just basically say we continue operating kind of as is and go longer term agreement to protect those from --

Erik Hoag: That's the intent. If you think about synergies and dis-synergies from Worldpay, I may break this up into 3 individual discussion points. On the revenue side, we had talked about roughly $750 million worth of synergies. And think about this as unlocking sales channels. This is on the loyalty premium payback product that sits in our Banking segment to retailers. This is selling our corporate treasury offerings in Capital Markets to the corporates that we have in Merchant. This is selling acquiring through our Banking and Capital Markets channels, though the financial institutions. We believe that commercial agreements can solve that. And the relationship between Stephanie Ferris and Charles Drucker, which is very strong, I think will help harden that in the industry that commercial agreements are successful.

On the cost side, we had talked about roughly $900 million worth of synergies really split between $500 million of OpEx synergies and $400 million worth of below the line synergies. On the below the line items, we're going to reconstitute a new balance sheet, new capital structure for Worldpay which will take care of that. And then the $500 million worth of operating expense synergies, and I know you didn't ask about the OpEx synergies --

Ramsey El-Assal: I was about to, so you're psychic.

Erik Hoag: I would think about this as, again, a lot of work underway. We've got operating expense synergies within the business and then we've got operating expense synergies that happen on the corporate side. And Charles right now is working on building out his organizational team. We're working on the entanglements associated with pulling these two organizations apart. A lot of focus associated right now on the OpEx side.

Ramsey El-Assal: Can you leverage, or are you leveraging sort of the Future Forward program to make some of the changes that we're talking about here? Or should we think about that as kind of technically sort of separate? I guess maybe you --

Erik Hoag: I think it's a good question. Future Forward is the initiative that FIS is running associated with driving incremental cash improvements. The program itself includes initiatives associated with OpEx savings. It includes programs associated with CapEx savings. It includes winding down some of the modernization programs that had been sitting in our non-GAAP add back line. It's really around driving cash. And we've had a lot of success. I'm going to deviate and talk about Future Forward for a minute.

As we ended the first quarter -- Future Forward broadly, we expect it to be roughly $600 million at the end of 2023. We ended the first quarter with roughly $200 million worth of CapEx savings, roughly $100 million worth of operating expense run rate savings. I'd say in the first quarter, really off to a good start with Future Forward. The initiative itself, it's really taken root within the organization, like a cultural change associated with trying to drive incremental cash across the organization. As we think about operating expense dis-synergies through the split, we're obviously going to lean hard into what can we incrementally do with Future Forward to help mitigate some of those dis-synergies.

Ramsey El-Assal: How should we think -- it might be early to ask this question, but post-spin, how should we think about the sort of balance sheet strategy, the capital deployment strategy of the FIS remain co? Is it the type of thing where you will be kind of staying within the lanes that you're in right now in terms of Banking and Capital Markets? How should we think about M&A versus returning cash to shareholders in the remain co, putting Merchant aside for a little bit?

Erik Hoag: Remain co capital allocation philosophy, we want to remain investment grade. We want to invest in the organization, in our product suite. There's organic and inorganic. It clearly had been towards organic investment. We want to continue to grow the dividend. We've got a 35% payout ratio today. I continue to expect a 35% payout ratio tomorrow. And then share repurchase. The spin itself will afford the ability for us to get back towards our target leverage ratio faster of 2.8. We're currently sitting at 3.2. And then from there, it is dividend growth, share repurchase, and potentially some tuck-in M&A.

Ramsey El-Assal: Okay, and I meant to ask you this too, timing? Any latest thoughts on timing of the spin?

Erik Hoag: A lot of parts to the spin. From carveout financials, the Form 10, the PLR, identifying the disentanglements associated with pulling the 2 organizations together. We're tracking.

With our fourth quarter call in February, we said within a year. We're tracking to the timeline we initially discussed.

Ramsey El-Assal: Okay. FedNow launching reportedly in July. What do you think about that product, that solution? Is it something that's going to have an impact? Maybe answer that in 2 ways. For you guys in particular, but more broadly, do you think it's something that will see widespread adoption? Or what?

Erik Hoag: I think too soon to tell. I'll tell you that at FIS we've got some customers signed up in pilot. We're moving forward, but right now, I think it's too soon to tell whether it's going to have a meaningful impact.

Ramsey El-Assal: Do you see the prior launch and rollout of the clearinghouse real time payments as sort of a proxy for the level of interest in that ecosystem? Or is this, is FedNow like a significantly different capability?

Erik Hoag: I'm not sure, Ramsey.

Ramsey El-Assal: Okay, all right, it was kind of a loaded question.

Erik Hoag: Yeah, I know. That's okay.

Ramsey El-Assal: I actually think it is. And then really, lastly, I also just wanted to get your quick read on just more broadly what you're seeing in terms of the regulatory environment in the markets where you operate. Are you seeing any increased activity? Do you see any kind of potential regulatory driven catalysts? One item for example is the Reg II and the addition of debit card routing, the new debit card option or network option to online debit transactions. There's a lot in that question, but regulatory environment tactically, strategically?

Erik Hoag: Yeah, and I'm going to answer it very broadly. Regulatory changes at FIS -- regulatory changes broadly are a benefit for FIS. We operate predominantly an outsourced environment for our customers on the Banking side and on the Capital Markets side. Whether it was IFRS 17 or the PPP program with COVID or PEBT, what we have found is it's an opportunity for us to help our customers. If regulators were to reevaluate FDIC limits, we think it's an opportunity for us to help our customers. We have found over the years it's an opportunity not just to help our customers, but it winds up manifesting itself in our P&L as well.

Ramsey El-Assal: Fantastic. Great conversation. Appreciate you being here. Thanks so much for joining us.

Erik Hoag: Thanks for having me.