

# MoneyGram

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February 13, 2007

MoneyGram, a leader in the market to transfer small amounts of money around the world has seen its revenues grow almost 20% year for the last two years. As those revenues grew by 19% in the latest quarter, its operating income stalled as the company started a price war among money transfer organizations (MTOs.) While the company dismisses pricing pressures as temporary, the latest data from the Banco de Mexico show remittance volumes falling in the heavy U.S. to Mexico corridor. This is in part due to a break in the construction boom on the West Coast, which has been a major employer of migrant workers, a trend that is unlikely to reverse in 2007 as large builders continue to announce layoffs.

As the volume of remittances slows, the number of major competitors in the market is expanding rapidly. The Banco de Mexico and the Federal Reserve have created a remittance program for banks that lowers fees to a fraction of those charged by MTOs, and the major U.S. and Mexican banks have acquired border banks to transfer funds at very low fees. In addition, new technologies have the potential to make a deeper impact on market structure. Internet companies now transfer money to India at a very low cost, and Xoom, with an ever-expanding network, charges as little as one-fifth of MoneyGram's fee. More importantly, a consortium of 19 mobile phone companies just announced a new global network with MasterCard that will allow 600 million phone customers to transfer money quickly at about half the cost of a MoneyGram remittance. MTOs Western Union, MoneyGram and DolEx all lowered prices in the latest quarter.

1. The growth in remittances worldwide at 13% per year since 2000 slowed to 4% in 2006. Remittance volumes in the key U.S.-Mexico market have fallen by 26% since May.
2. The U.S. to Latin America corridor produces the highest transfer margins, but competition is bringing those prices lower. In January conference calls, Global Payments, MoneyGram and Western Union confirmed a current price war in this market.
3. With the Directo a Mexico, a Federal Reserve and Banco de Mexico program, U.S. banks can now transfer funds to Mexico for only \$.67 and a tiny .21% mark-up on the exchange rate, a fraction of Western Union rates.
4. Both Mexican and American banks have made cross-border acquisitions in order to provide remittances cheap to attract new Hispanic customers.
5. Microfinance companies have emerged to appeal to ethnic segments and transfer money at lower prices, as have Internet services, many of which offer no commissions in major corridors. Xoom, backed by Sequoia and Fidelity, offers a major discount to MTO prices, and HSBC sends online transfers to India for free.
6. While MoneyGram revenues rose by 19% in the latest quarter, the growth in its operating profit fell to 9%. Wal-Mart accounted for a good part of the growth in its Global Funds Transfer in the last two years, but as Wal-Mart volumes grow, MoneyGram's payout rate rises.
7. Both Western Union and MoneyGram have been bought and sold several times in the last ten years. At one point, First Data owned both, but both were spun-off to the public in the last two years.

Summary Company Data			
Stock price (2/13/07)	\$29.34	Price/Earnings, tl 12 mos	20.2 x
Common shares out	84.1 m	Price/Earnings, Core eps	20.2 x
Market capitalization	\$2,467.49 m	Price/Earnings, Current est	18.6 x
Shares closely held	1 %	Price/Sales, tl 12 mos	2.1 x
Potential dilution	5 %	Price/Book Value	4.0 x
Average daily volume	1,066.1 k	Book Value (tangible)	\$206.6 m
Estimated daily dollar vol	\$31.3 m	Short interest, October	2.6 %
Debt/Capital (tangible)	19 %	Short interest, November	0.8 %
Auditor:	Deloitte & Touche	Short interest, December	1.0 %
Fiscal Year End:	December	Short interest, January	1.0 %



## Company Description (from Hoover's)

MoneyGram International has just the ticket to move money. Through its Global Funds Transfer unit, the company sells MoneyGram cash transfers, money orders, and gift certificates at more than 100,000 locations globally. It also offers in-person electronic

payment services, letting consumers pay utility bills at retail stores. The company's Payment Systems unit primarily serves banks and credit unions, which use MoneyGram International's services for official checks and share draft processing. The division also processes controlled disbursements (such as WIC checks and rebates) and sells money orders through financial institutions. The company issues more than 270 million money orders per year.

### The Bull Story

While the worldwide market for remittances has grown rapidly in the last six years, MoneyGram has grown even faster. As immigration has grown with the decline of trade barriers in the last decade, remittances have grown 13% per year since 2000. Outpacing that, MoneyGram revenues grew 19% in 2006 with its rapidly growing Global Funds Transfer segment increasing by 34%. A portion of that growth has been due to the company's success at signing new agents – it increased its number of agents by 12% in 2006 operating in over 110,000 locations worldwide. Even if migration slows, money transfer organizations (MTOs), such as MoneyGram and Western Union, still have room to grow – the market is highly fragmented, with MTOs only processing 25% of worldwide transfers.

### The Rapid Growth in Worldwide Remittances Has Cooled

Substantial growth in the volume of money transfers has generated strong revenue growth for MTOs, but the growth in dollar volume and number of transactions has recently slowed. Since 2000, the dollar volume of remittances worldwide grew 13% per year to \$270 billion worldwide. In 2006, however, the World Bank estimates that remittances grew only 4%. Migrants in the U.S. transfer the most money overseas, and four countries – India, China, Mexico and the Philippines – receive more than 25% of the world's transfers. The nationality of the sender impacts the structure of the market. For example, Latin Americans are more likely to distrust banks and use MTOs to send money; Indians, Chinese and Philipinos are more likely to use banks, or in some cases, the Internet and new technologies. One-third of global remittances flow between Asian countries where MTOs are less dominant.

### Demand: Remittance Volumes Have Slowed

Although the remittance market has grown rapidly, three factors affecting transfer growth – U.S. construction activity, migration demographics and a switch to electronic transfers from money orders – have all slowed or reversed.

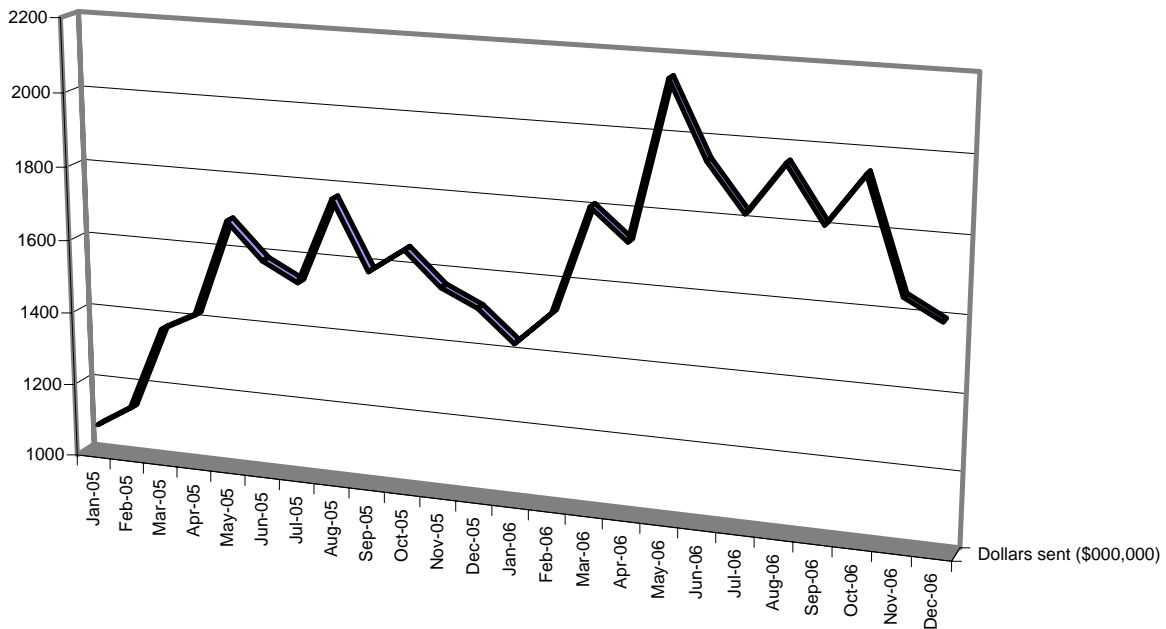
Because immigrants work in highly cyclical industries such as construction and other household services, remittance volume is very sensitive to economic cycles. Since 1994, the flow of migrants in the largest remittance corridor from Mexico to the U.S. has been closely correlated to macroeconomic trends in the U.S. economy (Pew Center for Economic Research, *Rise, Peak, and Decline: Trends in U.S. Immigration 1992-2004*.) In fact, since 2003 migration regained momentum because of the boom in the construction industry – immigrants created a disproportionate share of the new workers hired in construction and homebuilding. But, that source for jobs has reversed. The U.S. Department of Labor reports that home-building jobs fell by 47,000 in 2006 after rising by 638,000 in the last three years.

And, this decline has yet to reflect the full 24% drop in building permits during the same period because of the lag to finish projects. Homebuilders have announced huge layoffs in the last quarter, especially in key remittance corridors such as California, Florida and Texas. Usually cheery Wall Street analysts expect that employment in residential construction will fall by 20%, or 600,000 jobs, in 2007 (*MarketWatch*, February 6, 2007.)

Remittance volume also follows migration patterns, but migration, especially in the U.S.-Latin America corridor, has slowed since 2000. The migration boom has already gone through an accelerated period of growth. Annual migration to the U.S. peaked in 2000 at 1.5 million and has since declined by approximately 20%. Mexicans make up one-third of immigrants entering the U.S. with Latin Americans making up another one-fifth. Mexican migration also peaked in 2000 and subsequently dropped by 29%. Since 2003, immigration has risen slightly but not to prior levels.

In part due to the slowdown in the construction industry, remittance volumes from the U.S. to Latin America have softened. The Bank of Mexico reports that remittance volume for the U.S.-Mexico corridor has fallen in the fourth quarter. Data released by the Bank show that dollar volumes dropped to a new low in December 2006 after peaking in May. Year-over-year growth fell from 32.3% in January 2006 to 5.3% in December.

Monthly Remittance Volume from the U.S. to Mexico



Remittance data is much less timely from Europe, the Middle East and Asia, but there is evidence that these markets are also slowing. Migration from Asia peaked in 2002 and has fallen since then. And, MTO growth in Europe and Asia, especially India and China, will be more difficult for MTOs in part because banks play a more dominant role. One recent study

found that 56% to 70% of immigrants used a bank to transfer money back home and they were almost three times more likely to have a friend carry the money home than use an MTO (Asian Development Bank, *Workers' Remittance Flows in Southeast Asia*, 2006.)

Banks dominate the market for remittances to India by non-resident Indians abroad. ICICI Bank, with alliances with Wells Fargo in the U.S., Lloyd's in the U.K., DBS in Singapore and BBVA in Spain, processes over one-third of the remittances from the U.K. to India. Since April, HSBC has offered free money transfers to India from the U.K. and now offers free transfers from the U.S.

Unlike the Latin American market, 20% of the remittances to India are initiated online. Asian countries, such as the Philippines and China, have much wider Internet penetration, making comparison shopping easier. New technology has spawned a variety of low priced online remittance sites, such as thamel.com, which not only transfers money to Nepal but serves as a message center. Remit2India.com, which A.C. Nielsen ranks as the number one online transfer portal for NRIs, and money2India.com only charge \$3 to send \$500 to India compared to MoneyGram fees of \$10 to send \$300. Remithome.com also targets the 3 million Filipinos in the U.S. who represent the second-largest Asian immigrant group. It charges a flat \$10 fee to transfer any amount of money versus the MoneyGram's \$14 fee transfer \$300 and its \$55 fee to transfer \$899.

#### Supply: Everyone Wants In

While softer demand has recently pressured remittance fees, new competitors entering the market could have a more significant impact on long-term prices. The availability of electronic transfer services has expanded rapidly as traditional MTOs have expanded the number of their agents, banks have entered the market using remittances as lead-ins to lower income consumers, and new technologies have rapidly expanded the number of less expensive transfer channels. In the next five years, InfoAmericas expect the number of remittances through MTOs to fall by 25% (*LatinFinance*, April/May 2006) where it expects newer channels to take market share.

Western Union and MoneyGram dominate a fragmented remittance market with estimated worldwide shares of 15% and 7% respectively and seem to have the most to lose from new competition. DolEx (owned by Global Payments), and to a lesser extent RIA Envia (acquired by Euronet), have large, deep-pocketed parents that intend to compete with lower prices.

The rapid rise in dollar volumes to developing countries, especially in Latin America, has led to a situation where remittances now total more than official development assistance and, in many cases, more than official assistance and foreign direct investment combined. For many countries, remittances can exceed 10% of GDP and in some cases contribute as much as 30%. As a result, governments have been active participants in opening payment systems to reduce high MTO remittance fees.

Because of the importance of remittances to developing countries, the U.S. and Mexican governments have made a concerted effort since 2001 to foster greater competition

in remittance fees. The Federal Reserve and the Banco de Mexico created the “Directo a Mexico” remittance program that allows commercial banks to make transfers for Mexican workers who only need to show a matricula consular I.D. issued by Mexican consulates (*Wall Street Journal*, October 11, 2006.) Because these transfers take place through the Fed to the Banco de Mexico, the system is cheaper and safer for Mexicans transferring funds from the U.S. than through traditional MTOs. The exchange rate to consumers, for example, is a wholesale rate that is 21 basis points higher than Banco de Mexico settlement rate. To put this in perspective, Western Union often charges a spread 200 basis points higher than the wholesale rate. A June 2005 World Bank study concluded, “foreign exchange spreads on remittances for both Western Union and MoneyGram appear to be too high, even in volume corridors, and are not transparent to the sender.” (*Assessment of Remittance Free Pricing*, July 2005.) Western Union recently lowered its fees by narrowing its exchange spread.

With Directo a Mexico, the Fed charges U.S. originating banks only \$0.67 per transfer compared to a Western Union fee of \$12 to send \$300 from the U.S. to Mexico. Mexican banks do not charge the recipient any fees and offer unparalleled convenience. The Fed ensures that the program charges a lower exchange rate and costs as little as one-third that of other providers. While analysts tout Western Union’s and MoneyGram’s distribution, someone who uses Directo a Mexico can receive funds at 7,800 branches, 21,500 ATMs or 173,000 point-of-sale terminals.

The Latin American market now represents the largest remittance market in the world (*Inter-American Development Bank*) and is attracting more competition. In addition to the Directo a Mexico program the border consolidation of banks in the last two years now allows migrants to send money home for virtually no fee except a foreign exchange spread. The Latin American banks have become aggressive at building remittance services. Banamex and Bancomer now have wide distribution networks, and Bancomer Transfer Services, Mexico’s largest bank, processes 40% of the transfer volume to Mexico from the U.S.

Madrid-based BBVA, Spain’s second largest bank, bought Bancomer, Mexico’s largest bank, to focus on the remittance market as its cornerstone for global expansion. With a strong upper and middle class customer base and 24% of the banking market in Mexico, BBVA only recently turned to target the lower end of the market through remittances. In 2006, BBVA bought U.S. banks across the border, including Valley Bank in California, Texas Regional Bancshares, State National Bancshares and Laredo National Bancshares in Texas to offer cheap remittances to attract Hispanic customers.

HSBC, the global banking giant, began targeting lower-income customers in 2002 with the acquisition of Grupo Financiero Bital. Its transfer fee from the U.S. to Latin America through its Easy-Send program is as little as \$5 for a \$300 transfer compared to MoneyGram’s \$12 to \$18 fee.

U.S. banks also now have remittance products to target the unbanked – the last area for growth for mortgages, car loans and other banking services. Citicorp, Wells Fargo and Bank of America all have been developing programs for U.S. customers. Citibank owns Banamex and offers zero-cost transfers to Mexico. Bank of America created SafeSend to

process online remittances to Latin America. Wachovia offers Dinero Directo – a prepaid card that recipients can use at a Visa ATM anywhere in the world.

Large U.S. banks have so far only captured a small portion of the remittance business, in part because undocumented immigrants could not provide the necessary identification. But, banks now accept ID cards issued by foreign embassies, and recipients can receive funds at banks without an account. The Mexican consulates issue identification cards – Matricula Consula de Alta Seguridad – that undocumented immigrants can use to open a bank account in the U.S. Studies show that once immigrants open a bank account, their use of MTOs declines.

Although immigrants are often suspicious of banks, in just two years the percent of immigrants who used a bank or credit union to send a remittance from the U.S. to Latin America more than doubled, from 8% in 2004 to 19% in 2006. About 70% to 75% of Western Union customers have a bank account – the same likely holds true for MoneyGram customers.

With a large Hispanic base, credit unions have also expanded remittance services. The World Council of Credit Unions' International Remittance Network (IRnet) can transfer funds to 40 countries and 4,000 locations in Mexico alone.

Non-financial institutions also want a piece of the business. Independents such as the U.S. Postal Service have launched their own services. In 1996, the USPS formed a partnership with BBVA Bancomer to offer a service called Sure Money, or Dinero Seguro, to transfer money from post office branches. It offers some of the lowest rates and does not require that recipients have a bank account to collect funds. This month Monterrey-based Famsa launched banking services in its department stores in northern Mexico.

### Microfinance Companies and New Technologies Will Further Pressure MTOs

Traditional MTOs also face competition from new technologies that allow for a variety of low-cost transfers. According to the Inter-American Bank, “over the next five years, the [remittance] system can be entirely transformed, moving from the current “cash-to-cash” system into the electronic or digital transfer system of “accounts-to-accounts.”

Micro-finance companies are using new technology to focus on remittances and other small-scale banking services believe they can offer transfer services at a much lower cost *and* greater convenience. The majority of MFIs in the remittance market are already registered as commercial banks and many have already been agents for commercial transfer companies such as Western Union (*Remittances and Development*, Migration Policy Institute, 2006.)

For example, Microfinance International, a 2003 start-up based in Washington, D.C., charges one-third less than a MoneyGram transfer. By 2005, it had captured a 10% share of the transfer market to Bolivia. It began its distribution into Mexico in October 2005 with 3,200 outlets. It also created a partnership with UAE Exchange, a finance company headquartered in the United Arab Emirates with immediate transfer capabilities into 75 countries already in place. At the end of January, MFIC began offering one of the most

extensive networks in the world (*Business Week Online*, January 3, 2007.) Equally important, MFIC allows other microfinance companies to license and connect to its platform with just an Internet connection.

The Internet is a natural, low-cost vehicle for money transfers. Internet-based processor Xoom charges only \$2 to send \$300 to India compared to \$10 for MoneyGram's online services. Unlike MTOs, Xoom allows remitters to choose among a cash pickup, a debit card, a deposit to a bank account or home delivery.

### Consumers Will Soon Be Able to Transfer Money on Mobile Phones

The ability for consumers to transfer money quickly and cheaply using cell phones could be a disruptive technology for traditional MTOs. While there are only 1 billion bank accounts for 6.5 billion people in the world, there are now 3 billion cell phones. Cash transfer services are also now available on some mobile phones. Globe Telecom, one of the major telephone companies in the Philippines, recently introduced G-Cash that credits remittances to phone accounts and can then be transfer cash among phones. The transaction fee is a fraction of a MoneyGram transfer. Services such as Obopay are springing up for cell phones in the U.S. Obopay only charges \$.10 per transfer.

The scope of money transfer services on cell phones is about to change dramatically. On February 11<sup>th</sup> a group of 19 mobile phone operators with networks in more than 100 countries that represent more than 600 million customers have announced a global system for international remittances. MasterCard will pilot a global hub that will link national markets and local payment systems and make transferring cash as "easy as sending a text message." The phone companies will reduce costs to 2% of a transaction, which would compare to the 3% to 4% that MoneyGram charges. Sunil Bharti Mittal, chairman and managing director of Indian operator Bharti Airtel said, "It will revolutionize the money transfer industry with its advantages such as reach, easy of use, and lower transaction costs and provide immense benefits to people in developing nations such as India." (*Reuters*, February 12, 2007.)

### Price Competition

Because of softening demand and expanding supply, remittance prices are falling in the dominant U.S.-Mexico corridor. While Wall Street believes this softness is temporary due to publicity about immigration issues, it is more likely that other forces will pressure prices further. MoneyGram set off price competition a year ago when it dropped prices with a "simplified" tiered pricing. DolEx responded by lowering prices to retain its position as the low-priced MTO. In December, Western Union then cut prices, especially foreign exchange fees, along the West Coast.

In a conference call on January 5, 2007, Global Payments, which owns DolEx, confirmed the current price war. The CEO said its money transfer business continues to be impacted by, "an increasingly competitive pricing environment..." which he later characterized as "a price war." In its quarter ending in November, DolEx's average price of a transfer fell 7.4%. The CEO described the drop as "significant" and said pricing in the U.S.-Mexico corridor and fell each month as the quarter progressed. The pricing decline

continued into December. In addition to immigration issues and a stronger Mexican economy, he blamed price cuts by second tier MTOs wanting to build transaction volume, which DolEx matched. Global Payments expects prices to remain soft in 2007.

MoneyGram confirmed price softness in its January 24, 2007 conference call, as did Western Union in its conference call on February 1st. MoneyGram said, “We believe Mexico growth rates have trended downward because of economic conditions in the U.S., including fewer construction jobs as well as immigration concerns.” MoneyGram revealed that Western Union had been dropping prices along the West Coast, especially with foreign exchange spreads.

Western Union talked about price pressures in its October conference call and again in its February 1<sup>st</sup> conference call. In the quarter ending in September, the company identified lower fees and exchange spreads in the U.S.-Mexico corridor. This quarter, it admitted that price cuts in selected markets cost the company 3% of revenues. Even with higher volumes, Western Union’s revenues on transfers to Mexico were flat as the company lowered prices to maintain its market share.

#### Western Union Also Lowers Prices to Protect its Brand

Western Union also admitted in its conference call that it lowered prices in part to recapture volume lost from bad publicity it received in October. After the Arizona Attorney General last year criticized the company for poor reporting compliance of suspicious activity, he seized almost \$17 million of revenues from Western Union, an action recently blocked by the state supreme court. In a court affidavit, a state Department of Public safety inspector said, “Western Union’s corporate compliance section has for at least the past three years inadequately reported.” (*Arizona Republic*, October 13, 2006.) However, the fact that funds had been arbitrarily blocked made customers more skittish. In addition, Western Union’s image suffered again from a recently published book that revealed that the company gave unlimited access to the FBI and CIA after 9/11.

Federal regulators have warned U.S. banks that MTOs, such as Western Union and MoneyGram, pose a high risk of money laundering activity. The Patriot Act of 2001 requires MTOs to follow money laundering regulations, and regulators have held the banks responsible for monitoring their customers, which has become expensive and risky. As a result, Bank of America announced in August that it would no longer accept deposits from Western Union and MoneyGram. Citigroup had ended its relationships with money service businesses in 2001, followed by most major banks in the last year (*American Banker*, August 23, 2006.)

#### MoneyGram’s Valuation Ignores Low Quality Earnings

In spite of pricing pressures and evidence of declining transfer volumes to Latin America, MoneyGram’s stock trades at 20x earnings. This is inconsistent with the drop in the company’s year-over-year operating income growth which has slowed from 25% in December 2005 to 9% in the latest quarter. Equally important, most of MoneyGram’s pre-

tax profit comes from investment income, which has grown little in the last two years and would not seem to deserve such a high multiple.

On the surface, MoneyGram revenues have expanded rapidly, which could explain the stock's multiple. MoneyGram revenues grew by 19% in 2006, and its Global Funds Transfer segment – which accounts for 73% of revenues – grew by 27%. But, much of that growth comes from one account and margins have fallen. Since 2003, Wal-Mart has grown from 5% to 17% of company's total revenues. In 2005, sales to Wal-Mart grew to approximately \$74 million, accounting for 41% of the growth in the company's dominant Global Funds Transfer segment. In 2006, Wal-Mart sales grew to \$197 million, again providing about 41% of segment growth.

In spite of top-line growth, MoneyGram's operating income has not kept pace. MoneyGram has not helped margins with its Wal-Mart agreement that pays based on tiered-pricing, which means that as Wal-Mart's transfer volume rises, MoneyGram pays a higher percentage commission. Companies that depend on Wal-Mart for growth often end up watching margins decline.

So while MoneyGram revenues grew by nearly 20% in 2006, its income from continuing operations grew just 10% with year-over-year growth in the last two quarters slowing to 9%.

In addition to slower operating income growth, most of MoneyGram's pre-tax profit comes from investment income as shown the following table.

<b>MoneyGram International Investment Income</b>								
	<i>Mar05</i>	<i>Jun05</i>	<i>Sep05</i>	<i>Dec05</i>	<i>Mar06</i>	<i>Jun06</i>	<i>Sep06</i>	<i>Dec06</i>
Investment revenues (\$mm)	89.502	95.801	91.634	95.801	94.960	106.516	96.406	97.607
Investment commissions	57.953	61.607	60.889	61.607	58.789	63.036	63.520	63.896
Net investment income	31.549	34.194	30.745	34.194	36.171	43.480	32.886	33.711
Income from continuing ops	35.657	36.305	38.874	35.539	45.688	51.818	41.960	37.307
Year-over-year growth	48.3%	53.3%	16.2%	24.7%	28.1%	42.7%	7.9%	5.0%
Investment inc % cont ops	88.5%	94.2%	79.1%	96.2%	79.2%	83.9%	78.4%	90.4%

In the last two years, investment income has produced anywhere from 79% to 96% of income from continuing operations. This is largely due to the interest on the float for transfers, which has not grown much since March 2005. In December, investment income actually fell 1% year-over-year. Low-growing interest on investments does not usually command a 20x multiple.

### Catalysts

- If monthly volumes in the critical U.S.-Mexico corridor continue to decline year-over-year, it would dispel assertions that the decline in remittances is temporary. It might signal weakness in upcoming earnings announcements and cause analysts to lower estimates.

- Continued or growing price competition in reported weekly remittance fees would also confirm ongoing price competition, which will pressure margins and hurt earnings.
- Legislative initiatives to restrict immigration or levy a tax on remittances would hurt formal transfer services. Any new legislation requiring a full disclosure of remittance fees could hurt MTOs that charge a wider spread on difficult to understand exchange rates.