Fund Update: 31 December 2016

Magellan High Conviction Fund

ARSN: 164 285 947

Fund Facts

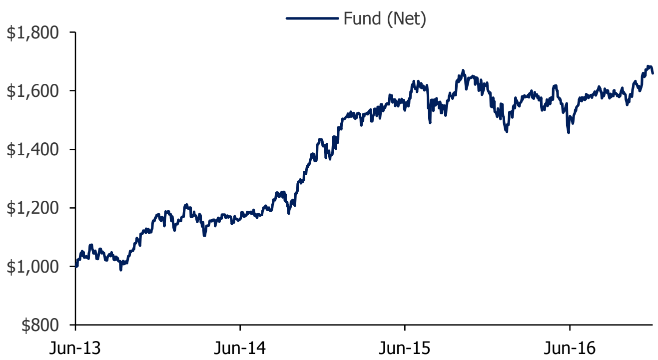
Portfolio Manager	Hamish Douglass
Structure	Global Equity Fund
Inception Date	1 July 2013
Management & Administration Fee[1]	1.50% per annum
Buy/Sell Spread[1]	0.10%/0.10%
Fund Size	AUD $301.4 million
Distribution Frequency	Annually at 30 June
Performance Fee[1]	10.0% of the excess return of the units of the Fund above the Absolute Return performance hurdle (10% per annum). Additionally, the Performance Fees are subject to a high water mark.

[1]All fees are inclusive of the net effect of GST

Fund Features

- Unconstrained, long-only, highly concentrated
- High quality global equity fund
- High individual stock exposure – 8 to 12 stocks
- Ability to actively hedge currency exposures, currently 39% hedged to AUD†
- Maximum cash position of 50%
- $10,000 minimum initial investment.

Performance Chart growth of AUD $1,000



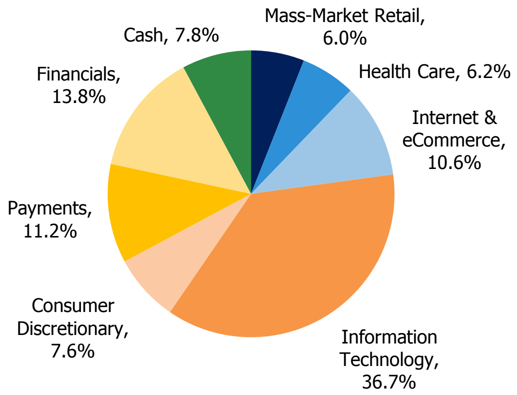
Fund Performance*

	Magellan High Conviction Fund (%)	Magellan Global Fund (%)
1 Month	2.7	3.4
3 Months	4.6	6.0
6 Months	9.6	9.2
1 Year	3.5	3.7
3 Years (% p.a.)	12.1	11.0
Since Inception (% p.a.)	15.6	

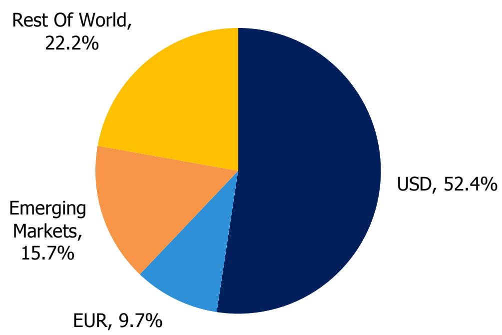
Top 5 Holdings

In alphabetical order	Sector
Alphabet Inc	Internet & eCommerce
Apple Inc	Information Technology
Lloyds Banking Group PLC	Financials
Microsoft Corp	Information Technology
Visa Inc	Payments

Sector Exposure by Source of Revenues#



Geographical Exposure by Source of Revenues#



† The Fund is currently exercising its ability to hedge some of the capital component of the foreign currency exposure of the Fund arising from investments in overseas markets back to Australian dollars.
* Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Fund Inception 1 July 2013. Returns denoted in AUD.
# Calculated on a look through basis based on underlying estimated revenue exposure of individual companies held within the portfolio - Magellan defined sectors.

Market Commentary

The December quarter commenced with divergent performance across the major equity markets in October in response to US corporate earnings data, currency fluctuations and increasing market expectations of a December interest rate hike by the US Federal Reserve (Fed). Equity markets were also significantly influenced by political developments during the period, primarily in relation to the US election and the Italian constitutional referendum. The Trump/Republican win pushed US bond yields higher as markets priced in a steeper rate rise trajectory by the Fed and consensus grew that expansionary economic policies will be implemented. Sentiment shifted towards growth-oriented sectors which are perceived beneficiaries of Trump's policy agenda of corporate and individual tax cuts along with increased spending on infrastructure and defence. Against a backdrop of continuing positive trends in key economic indicators, the US equity market continued to perform well and the US dollar appreciated to a 14-year high in December.

The euro weakened for the quarter, while most major European bourses staged a strong rally following the Italian constitutional referendum in early December to end the quarter at or near their high point for the year. Italy's stock market was the best performer of this group, rising by more than 20% over the quarter, however earlier losses preceding the fourth quarter meant the Italian market finished 2016 largely unchanged from the beginning of the year. Concerns have been escalating over the country's banking system, which has amassed large concentrations of non-performing loans, discussed in detail below. In December the Italian Government announced a €20 billion bailout fund to support the banking system. Despite the nominal gains achieved in European equities, falls in the euro and British pound against the US dollar limited, or in some cases, negated these gains for investors domiciled outside of these currencies.

There was significant dispersion at a sector level for the quarter, with advances led by the financials, industrials, energy and materials sectors which are perceived as beneficiaries of the prospective growth-oriented environment. Energy was the standout sectoral performer, aided by a stabilising oil price and OPECs decision to cut crude oil output for the first time since 2008. Higher growth and inflation expectations have fuelled expectations for interest rate increases and consequently, bond proxies such as utilities, consumer staples and real estate exhibited weakness.

Fund Commentary

As of 31 December 2016, the Fund consisted of investments in 11 companies, consistent with the number held as at 30 September 2016. The top five investments represented 52.5% of the Fund on 31 December 2016, while they represented 52.2% of the Fund on 30 September 2016. The cash position has decreased marginally to 7.8% as at 31 December 2016 from 9.1% at the end of September.

Microsoft was the largest contributor to returns for the period. Microsoft has continued to perform well following another strong earnings result which exceeded its guidance targets and consensus estimates. The result featured continued revenue growth within its Productivity and Intelligent Cloud businesses with only a modest contraction in revenues from its Personal Computing segment. Microsoft continued to register gains in December, reflecting support for the technology sector. Apple was another key contributor after the stock posted strong gains through the second half of the period. Apple's latest quarterly earnings result was overshadowed by a 9% fall in quarterly sales, which was broadly in line with guidance. However, the company reported continued growth in its installed base of users and positive indications from its upgrade programs following the recent release of the iPhone 7 and 7 Plus phones.

There were no material detractors from returns within the Fund's largest holdings this quarter.

Investment Update

We remain cautious about the outlook for equity markets over the next few years, given the environment of abnormally low interest rates, historically elevated price-earnings multiples, risks associated with the recapitalisation of the Italian banking system and the continued withdrawal of US monetary policy stimulus. Notwithstanding the current macroeconomic uncertainty, we retain confidence in the quality and long-term outlook for our investments and are comfortable with the Fund’s overall risk profile and construction.

Consistent with the stance held over the past two years, we retain a large weight in cash to preserve capital and continue to apply a consistent approach to selecting high quality companies that are well positioned to deliver satisfactory returns over the long term. Many of these companies are structurally advantaged through their exposure to the following major investment themes that are prevalent within our global equity portfolios:

- **Consumer technology platforms**: The leading digital platforms have tremendous opportunities to monetise new services and products (even when they are not the originator). With high switching costs and barriers to entry, their entrenched positions are unlikely to be challenged in the foreseeable future.
- **Enterprise software**: Established enterprise software vendors benefit from their incumbency. They typically operate in concentrated markets with high barriers to entry, network effects, and high switching costs. The shift to cloud computing presents a significant opportunity for leading vendors to expand their addressable markets and win a greater share of total enterprise IT expenditure.
- **Health care and ageing population dynamics**: The health care sector has attractive growth tailwinds due to rising patient volumes, increasing expenditure and large unmet healthcare needs.
- **The move to a cashless society**: There continues to be a strong secular shift from spending via cash and cheque to cashless forms of payments, such a credit cards, debit cards, electronic funds transfer and mobile payments. The explosion of smart and internet connected devices will accelerate this shift on a global basis.

Market risk update

Interest rates

Since the election of Donald Trump as the next President of the United States, 10-year US Treasury yields have increased approximately 70 basis points (bps), the largest increase since the "taper tantrum" of mid-2013, to around 2.5% - the level at which they traded 12-18 months ago. In response, the trade-weighted US dollar increased around 5%, while interest rate sensitive equities have been re-priced. In the month post the election, the S&P500 Financials index increased by around 18%, while bond proxies such as the utilities and consumer staples sectors fell by around 4% and 3%, respectively. Rising bond yields reflect market expectations of reform and fiscal stimulus and a hastened exit from ultra-stimulatory monetary policies. Notwithstanding recent market moves in interest rates, we continue to believe that asset prices broadly reflect a distorted reality, and expect further re-pricings as interest rates normalise.

In our view there are two phases for interest rates that are relevant to investors. Over the next five years we expect to see rising interest rates, as central banks withdraw their extraordinary monetary policy stimulus. Looking out a further 10 years, rates may decline again as technological disruption, including dramatic advances in artificial intelligence, generate structurally lower inflation pressures.

We have previously written about the dangers of quantitative tightening, which is likely to play out over the next five years. The issue is whether asset prices predominantly reflect the current economic reality, or whether they are being significantly distorted by the extraordinary monetary policy (including asset buying) and foreign exchange policies of the G7 central banks[1]. As central bank asset purchases diminish over the coming years there is the potential for material declines in some asset prices.

A key reason that asset prices remain elevated is the ongoing quantitative easing programmes of the European Central Bank (ECB), Bank of Japan and Bank of England (approximately US$130 billion per month combined), and the fact that the Fed has not yet started shrinking its balance sheet.

The politics and economics of Europe will likely have a key influence on the direction of global monetary policy and currencies over the next few years. Indeed, a number of important elections are taking place in the eurozone in 2017, including France, Germany and possibly also Italy. While anti-establishment parties could perform strongly, we believe there is a very low probability of a catastrophic market event where a country leaves the eurozone. Nonetheless, political instability in Europe could lead to a delay in monetary policy normalisation in the US, given the interconnectedness of global capital markets.

There are some commentators who believe that the central banks will need to implement even more aggressive forms of monetary policy, such as the monetisation of government debt or a helicopter drop[2] of printed money in order to induce inflation. Such policies are almost certain to create inflation via the devaluation of money. If such policies were to be implemented, interest rates would almost certainly need to rise in response to rising inflation. While we are unable to handicap whether central banks will go down this path (although we do not believe it is likely in the US or Europe), we would caution investors about the medium-term impact on asset prices of such action. Initially, investors may react euphorically to more monetary stimulus; however, asset prices will eventually react to the prospects of rising inflation and interest rates. While we continue to believe that it is more probable than not that the Fed will tighten monetary policy over the next few years, we have moderated our expectations on the extent of the likely rise in longer term bond yields over the next three to five years. It is prudent to remain cautious in this environment.

Longer term, we need to ask what will be the impact of technological disruption on the risk free rate. Are we going to eventually see massive productivity gains and deflationary forces through huge enhancements in technology, particularly artificial intelligence? How will these changes impact different business models and over the very long term, how will this affect the valuation of assets and interest rates?

Recapitalisation of the Italian banking system

It has been estimated that the Italian banking system is holding around €360 billion of non-performing loans and if banks were required to write down these loans to current market values the Italian banking system could be required to raise up to €40 billion of new capital. The issue is that the most vulnerable banks are not able to raise new capital and while the Italian government has recently created a €20 billion bailout fund for its troubled banks, under European Union (EU) rules they are not able to provide financial assistance unless a bank's shareholders and creditors bear losses equivalent to 8% of the bank's liabilities. Critically, the junior debt, which is first in line to be "bailed-in" is largely held by retail investors. The risk is thus that a large bail-in of retail bonds could trigger a widespread depositors run on the Italian banks.

The Italian Government is currently in negotiations with Brussels about the extent of losses that must be forced upon the holders of junior debt as part of a recapitalisation of the banking system, involving aid from the Italian Government. There may well be more market volatility ahead, depending on the outcome of these negotiations. The resignation of Prime Minister Matteo Renzi in the aftermath of the failed constitutional referendum could complicate the process of finding a resolution to Italy's banking system problems, with the possibility of an early election and increasing power for anti-establishment parties such as the Five Star Movement leading to further political instability. However ironically, the defeat of the referendum reinforces gridlock in the Italian political system and makes it harder for anti-establishment forces to take Italy out of the Eurozone, lowering the probability of this tail risk. We thus continue to consider an exit from the EU by Italy to be a very low probability event.

The election of Trump

We are fairly relaxed about the advent of a Trump administration for our investment portfolio. Trump's economic policies such as tax cuts and spending on infrastructure and defence are broadly stimulatory, so there is likely to be some upward pressure on growth, inflation and interest rates in the medium term, which has been priced by bond markets. However, there are potentially conflicting policy objectives between Trump and Congressional Republicans' who tend to want 'smaller government' and reduced Federal debt, which creates some policy uncertainty. Republican control of the Senate, the House of Representatives and the White House should reduce policy gridlock in Washington DC.

Nonetheless, we expect the near term to bring bouts of elevated market volatility, as markets do not like surprises and there remains great uncertainty on the actual policy platform that Trump, and the majority Republicans in Congress, will seek to enact.

The most material risk from a Trump administration, while low probability in our view, comes from trade and foreign policy. Trump's 'fair-trade' platform focuses on much more favourable outcomes for the US within its free trade agreements and holding China accountable for alleged unfair trade practices. In the event of a low probability 'trade war' scenario, some businesses with operations and/or large markets in China or Mexico could be adversely affected. Apple is one such example.

As we stated heading into the election, and have discussed at length, we continue to believe that there are other macro issues which are more important than the US election for markets and our portfolio, including:

- Risks associated with monetary policy and the massive distortions in fixed income markets caused by central banks
- European political risks, particularly the rise of euro-sceptic parties, and the Italian banking system
- China's financial system risks

[1] US Federal Reserve, European Central Bank, Bank of Japan, Bank of England, People's Bank of China, Saudi Arabian Monetary Agency, Swiss National Bank.
[2] A term coined by Milton Friedman in 1969 that describes the printing of money by a central bank, which is then distributed to households to spend as they wish. This would stimulate aggregate demand, as well as debase the currency, since there would be more money chasing the same goods and services.

Global economic update

Our views on the world's largest economic zones have not changed materially since our last update. Our base-case outlook for the next three years assumes a continued recovery in the US with modestly rising inflation, a continued slowdown in China (but not a financial crisis or hard landing) and an improvement in the economic outlook for Europe.

United States
A range of economic indicators show that the US economy continues to recover, albeit with some headwinds.

The US is driven by households, with consumption comprising around 69% of US gross domestic product (GDP). The household sector has been buoyed by strengthening labour markets, rising house prices, lower debt, falling commodity prices, a strengthening US dollar and low interest rates. Average weekly earnings increased by 2.2% over the year to November 2016 and the number of people employed is now 152 million – over five million more than the previous peak in November 2007. Higher goods and services consumption by households is supporting a growing corporate sector and rising corporate profits. As household formation returns to normal, we expect housing starts to grow further to at least 1.3-1.4 million per annum, this being our estimate of normalised demand. Improvements in the household and corporate sectors are flowing through to the banking sector, with total loans and leases outstanding increasing by 7.7% per annum and notably, commercial and industrial loans increasing by 8.8% over the year to November 2016.

The government sector's drag on the economy has abated. The Congressional Budget Office forecasts the federal deficit to remain fairly stable at 2.5-3.0% of GDP over the next few years. While the fiscal policy implications of the incoming Trump administration remain uncertain, additional short term stimulus appears likely.

Although the US economy is facing some headwinds, most are likely to be transitory. Headwinds include the impact of a stronger US dollar and a weaker global economy on trade-exposed industries, a contraction in energy sector activity, and weakness in industries and regions reliant on oil and gas production and investment. Despite the challenge of the rising US dollar, the US is a predominantly domestically driven economy, with a relatively low reliance on exports (which account for approximately 12% of GDP).

Tighter labour markets will lead to faster growth in real wages and potentially lower profit margins for businesses that lack pricing power. Meanwhile, scope remains for further job creation due to underemployment and the cyclically depressed participation rate. The 'U6' unemployment rate, which includes part-time workers who want a full-time job and those marginally attached to the labour force, has been falling steadily since the global financial crisis (GFC) but remains elevated at 9.3%[3]. The U6 has fallen to 8% or lower in previous cycles. Furthermore, the proportion of 25-54-year olds in the labour force has fallen from just over 83% before the crisis, to 81.5% as at November 2016.

Several transitory factors have been keeping inflation below the Fed's 2% target. However, as the oil price bottoms out, the US dollar stabilises and the labour market continues to tighten, wage growth and inflation pressures are likely to normalise. Consistent with previous cycles, this will require the Fed to progressively tighten monetary policy towards the long-run neutral Fed Funds rate, which is probably around 3%.

Overall, we expect the US economy to continue along its path of a steady recovery over the next few years, barring unforeseen events.

Eurozone
Real GDP growth in the eurozone remained modest at around 1.7% p.a. over the year to September 2016. A number of the periphery economies are continuing on their recovery path. Spain and Ireland's annual growth rates remained strong at 3.2% and 6.6% p.a. respectively, while Greece recorded its highest rate of annual growth since mid-2008 of 1.6% p.a. However, we remain cautious about risks from Italy's ongoing economic malaise, undercapitalised banking system, tightening credit conditions and political uncertainty.

The eurozone as a whole is likely to continue benefiting from a weaker currency, a stronger US economy, lower commodity prices, and an improvement in borrowing conditions and credit flows in an environment of ultra-low interest rates. However, the pace of eurozone growth is likely to remain modest for the foreseeable future as high levels of government debt, unresolved banking system issues, political uncertainty, and poor demographics hold back the economy.

Labour markets are gradually recovering in the eurozone, although considerable slack remains. Over the year to September 2016, aggregate employment increased by 2.1 million to reach 153.2 million, but remains below the pre-GFC peak of 154.4 million. The aggregate unemployment rate has fallen from 12.1% in June 2013 to 9.8% in October 2016. Although the improvement in Eurozone labour markets has been broad-based, Italy's unemployment rate is little changed in the past year and remains elevated at 11.6% in October 2016. While relative wage cost competitiveness of periphery economies is gradually improving, such internal devaluation is proving to be a painful mode of adjustment.

The rise of euro-sceptic political parties in a number of eurozone countries reflects a long period of adjustment following deep recessions and accompanying high levels of unemployment, which has created difficult policy choices for governments. These parties often threaten an exit from the eurozone (and a dispensing of the euro as currency) and/or debt defaults, which could spark renewed uncertainty in sovereign debt markets. When considering political risks, it is important to distinguish between the nine nations that are members of only the EU, and the 19 nations that are members of both the EU and the eurozone (whose currency is the euro). There is no existing legal mechanism for a country to leave the eurozone, and an exit by a country would be extremely problematic and have far more material systemic implications than a country seeking to leave the EU, such as with Brexit. We place a very low probability on such a scenario.

Nonetheless, the eurozone remains vulnerable to major shocks, such as an escalation of geopolitical tensions with Russia, the election of euro-sceptic parties into government or an Italian banking system crisis. Each of these scenarios could trigger a dramatic uplift in periphery eurozone sovereign bond yields, and would heavily test the resolve and mandate of the ECB.

Overall, we expect a continuing gradual recovery in the eurozone, but remain cautious about material downside risks.

China

While we remain concerned about the short- to medium-term outlook for China, we do not believe that China is about to have a financial crisis or experience a hard economic landing.

China's rapid economic growth in recent years has been unsustainable. When demand for Chinese manufacturing exports deteriorated in the GFC, China launched the largest credit stimulus in history, fuelling an investment boom that continues today. From 2008-2013, China's state-owned banks issued new credit totalling US$10 trillion, equivalent to the entire US banking system. Although credit growth has slowed, it continues at around 13-15% per annum. The source of credit expansion has recently shifted from companies to households, reflecting policy shifts to support consumption and demand for new home loans from households, which accounted for 73% of all bank lending in Q3 2016. The problem is that GDP benefits from new loans have fallen from around 75 cents per dollar of loan to just 20 cents. Currently, it is estimated that US$1.3 trillion in corporate loans are owed by Chinese companies whose profits aren't sufficient to cover interest payments, which suggests potential bank losses of around 7% of GDP (excluding shadow banking exposures).

Almost half of China's credit growth since the GFC (or around 50% of GDP) may have gone towards financing property market activity. There appears to be approximately four years of excess housing supply in China, comparable to recent property booms in the US, Spain and Ireland. According to the China Household Finance Survey, 22% of urban housing in China is vacant. Meanwhile, vacant floor space on developers' books has increased by around 500% since 2007. Property prices are growing rapidly in Tier 1 cities with supply shortages, however this is not the case in lower-tier cities where most of the excess supply is located.

The potential implications of China's property oversupply are serious. Real estate and related industries account for 20-25% of China's GDP. Fiscal positions are vulnerable, particularly for local governments who have relied on land sales for 35-40% of revenues. A large contraction in China's property construction sector would cause a major slowdown in the economy and perhaps even a recession.

Although economic data out of China is problematic, a range of indicators suggest that China's economy is slowing as the housing oversupply problem broadens. Weakness is most apparent in the industrial space (41% of GDP), a large portion of which is linked to property. Cement production expanded slightly by 1.3% per annum in the last 12 months, compared to 11% growth per annum in the decade prior. Steel production and electricity production grew at a modest pace while freight traffic contracted substantially in the past year. Although industrial sector data showed signs of improvement in early 2016, we believe this is due to a temporary credit impulse by the Chinese Government and households speculating on the property market. Real trade data also shows that both import and export growth has slowed significantly.

Since 2010 China has contributed around a quarter of total global economic growth, despite its economy only representing around 12% of world GDP. We are cautious about adverse knock-on effects, including currency movements, linked to changing economic fortunes in China. A number of commodity exporters such as Russia, Brazil, Australia and Canada have experienced material depreciations in their currencies against the US dollar as commodity prices have fallen. Russia and Brazil have experienced deep recessions. These economies may still be vulnerable to the unwinding of commodities-linked domestic credit booms. Other Asian economies with strong trade and financial linkages to China could also be at risk.

The outlook for the Chinese renminbi, which has appreciated around 45% on a real trade-weighted basis since 2005, is uncertain and difficult to predict. While continued RMB depreciation is likely due to capital outflow pressures and rising wages, a large devaluation is less likely. In 2016, China introduced new and tighter capital controls that appeared to temporarily stem capital outflows and stabilise the renminbi. However, in recent months there have been renewed signs of capital outflows, a decline in foreign exchange reserves and a resumption of renminbi depreciation.

Chinese policymakers must carefully manage the credit and property excesses in its economy. If China moves too quickly to address the moral hazard and implicit government guarantees in its financial system, this could lead to a tightening of credit conditions and a pullback in loan demand from the private sector, triggering an economic downturn and possibly a panic in the poorly regulated shadow banking system. On the other hand, if credit stimulus continues unchecked or is ramped up to maintain GDP growth rates, returns to new credit may diminish further and result in material loan losses in the future.

The Chinese leadership appear to be aware of the problems and have the policy tools needed to stabilise the economy. This makes a financial crisis unlikely. Fortunately, most of China's debt is held domestically, which makes it easier for the Government to manage large-scale defaults as it did in the late 1990s. Further monetary stimulus will almost certainly be deployed to reduce interest burdens and ease banks' reserve requirements. Meanwhile, a huge pool of foreign exchange reserves and a large current account surplus make China resilient to external financial shocks.

[3] Marginally attached to the labour force are those who currently are neither working nor looking for work, but indicate that they want and are available for a job, and have looked for work sometime in the past 12 months.

Key stock in focus - Visa

Introduction and history

Visa Inc. owns the world's largest global payments network. There are over 3.1 billion Visa credit and debit cards issued to customers by 16,800 financial institutions, on which there were 83.2 billion transactions conducted over 2016, representing US$8.2 trillion. Visa cards were accepted at more than 44 million merchant locations and Visa operates across more than 200 countries and 160 currencies.

Visa's history began in 1958 when Bank of America launched BankAmericard. This was the first general purpose consumer credit card targeted to middle-class consumers that was accepted at small to medium-sized merchants in the United States and came with a US$300 credit limit. BankAmericard was launched internationally in 1974 and then rebranded as Visa, a simple name that sounds the same in every language. Visa Inc. was listed on the stock exchange in 2008 when it was demutualised by its former bank owners, except for the Western European business. Then, in June 2016, Visa Inc. purchased the Western European business from Western European banks for a maximum price of €18.5 billion.

A privileged payment network business

Visa provides a network that 'switches' payment information between cardholders' banks and merchants' banks around the globe. It does not have direct relationships with cardholders and merchants, rather, it relies on banks to intermediate those relationships. Importantly, Visa does not extend credit to cardholders, with those facilities being extended by banks.

Visa is a privileged member of a select group of global payment networks, alongside MasterCard, American Express and PayPal. Indeed, PayPal is the only new successful global payment network since the launch of MasterCard in the 1960s. It is extremely difficult to establish a payments network, because there needs to be simultaneous acceptance of the network by both consumers and merchants. This requires mass awareness, simplicity of payment, technology ubiquity, fulfilment of arduous customer and merchant servicing needs, as well as strict regulatory requirements.

Visa competes not only with other global networks, but against all forms of payment, including paper-based payments being primarily cash and cheques. Visa also competes with networks that focus on specific regions, such as JCB in Japan. Visa's payment volumes are twice as large as MasterCard's and almost seven times the size of American Express'.

Multiple products linked back to the network

There are four core card products. Debit cards are issued by banks to allow consumers to access funds held in their bank transaction accounts. Credit cards are issued by banks and allow consumers to access credit to pay for goods and services. Prepaid products draw funds from pre-funded designated pools of funds. Lastly, commercial cards provide corporate and purchasing card products for businesses.

Visa's non-card product lines include VisaNet, Visa Checkout and CyberSource. VisaNet provides processing infrastructure that authorises, clears and settles transactions. Not all Visa-branded transactions are actually undertaken on VisaNet, with domestic processors undertaking this function in certain countries. VisaNet is capable of handling more than 65,000 transactions per second. VisaNet permits analysis of each authorisation and allows Visa to provide additional value-added services to banks and merchants, including risk-scoring and tokenisation. Tokenisation helps protect consumer details and reduce fraud by replacing card account numbers from the transaction with a token that can only be used once.

Recently introduced products focus on e-commerce and digital wallets. Visa's CyberSource business is a full-service merchant gateway that enables online and in-store payments across multiple payment mediums. Visa Checkout is a digital wallet enabling easy and secure payment for online transactions which permits consumers to load multiple cards into the wallet. Rollout of Checkout is in the early stages, with 15 million consumer accounts in operation across 21 countries. Digital wallets are important in facilitating easier e-commerce and mobile payment experiences for consumers.

Revenue streams

Visa charges fees to its banking clients based on small percentages of the value of transactions. There are three primary fee streams. Service revenues are charged by Visa for the provision of its branded network to client banks. Data processing fees mostly relate to the VisaNet business, while international transaction revenues are earned through cross-border transaction processing and currency conversion fees. Visa earned US$15.1 billion in net revenues in 2016.

More than half of operating revenues are from well-diversified operations outside of the United States. Payment volumes from the United States account for 41% of the total, Europe 25%, Asia Pacific 22% with the remainder from Latin America, Central Europe Middle East Africa and Canada.

Key risk considerations

Government and regulatory interventions in payment systems represent a key risk to Visa. An increasing number of governments regulate the interchange fees (pass-through fees paid by merchants to card-issuing banks), which may impact Visa's competitive position in a market and may also tilt consumer usage away from higher-fee credit cards towards lower-fee debit cards. Certain governments, such as Russia, China and India, have recognised the systemic importance of electronic payments and have favoured domestic processors.

Competition in the payments sector is increasing, with the big players of the technology sector seeking to expand their capabilities in the mobile payment space. Apple Pay, Samsung Pay, and Android Pay are all offering mobile and in-app payment facilities via their mobile handsets and through over 1,000 applications. Microsoft and Facebook also have plans to develop their own payment methods. These companies do not have direct payments relationships with consumers and merchants, rather, these payment capabilities leverage the existing infrastructure of the payment networks (including Visa), banks and merchants. Indeed, higher growth in mobile payments, encouraged by the technology sector, actually increases the usage of Visa's network.

Innovation also presents a risk to Visa. Possible developments in block chain technology or digital currencies may displace some of Visa's business or increase price competition. Also, various governments and entities are advancing the development of near real-time transfers between bank transaction accounts, a service which could compete with Visa's debit business.

Industry prospects and growth

In a decades-long global trend, the means of payment continues to shift from cash and cheque towards electronic payments. This is being driven by various factors, including convenience, necessity as commerce shifts to online, and changes in public policy. This trend has a long way to go. The number of cash payments in many developed economies still comprise more than 50% of transactions and in developing countries, more than 90% of transactions. This trend supports growth rates in electronic payments which are a multiple of nominal global GDP growth.

Visa is a highly scalable business with continued strong growth prospects as electronic payments take share away from cash and cheques. Visa's position as the largest payments network in a privileged industry, which operates as a rational oligopoly, is evidenced by consistently reporting operating margins in excess of 60% and EPS growth of almost 20% over the past four years.

Electronic payment growth trends mean that Visa is likely to enjoy payment volume growth in excess of global nominal GDP growth. This, with visibility of revenue and expense synergies from the integration of the Visa Europe business, mean that it is very likely Visa will achieve earnings per share growth in the mid-high teens over coming years.