



Third Quarter 2023 Analyst Call | November 1, 2023

C O R P O R A T E P A R T I C I P A N T S

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C O N F E R E N C E C A L L P A R T I C I P A N T S

Colin Sebastian, *Baird*

Ashwin Shirvaikar, *Citi*

Sanjay Sakhrani, *KBW*

Dan Perlin, *RBC*

Trevor Williams, *Jefferies*

Tim Chiodo, *UBS*

Andrew Jeffrey, *Truist*

Paul Golding, *Macquarie*

Ken Suchoski, *Autonomous Research*

P R E S E N T A T I O N

Operator

I would like to welcome everyone to the PayPal's third quarter 2023 earnings analyst call. All lines have been placed on mute to prevent any background noise. I will now turn the conference over to Gabrielle Rabinovitch. You may begin.

Gabrielle Rabinovitch

Thanks, Krista. Thanks, everyone, for joining us and thanks for being on the call with Alex earlier. We're going to just run this like we normally do. I think we plan to go about 30 minutes and we'll try to get to as many questions as we can during that time. Krista, we can get started.

Operator

Your first question comes from the line of Colin Sebastian from Baird. Please go ahead. Your line is open.

Colin Sebastian

Thanks for taking the question. Hey, Gabrielle. I guess I first off I wanted to follow up on branded checkout. Maybe what you saw specifically impacting the growth rate through Q3. Was that really just reflective of broader e-commerce slowing down a bit? Is that Europe or is that global?

And then with respect to Alex's comments on branded checkout and competition and market share. Just curious the vision in terms of how this part of the platform needs to change or adapt to keep share or build share. Any product enhancements or functionality that you think should be added sooner rather than later? Thank you.

Gabrielle Rabinovitch

Yes, Colin, great to catch up. Maybe just to start in terms of branded checkout TPV growth, and I want to orient everyone to what the trend through the year has been. Q1 was 6.5% global TPV growth [FXN]. Q2 was 5% [FXN]. Q3 for the quarter in total was 6% [FXN]. And what we said just a few minutes ago when we were on the main [Q3 2023 Earnings] call was that Q4 to date, we've seen very consistent trends with that global branded TPV growth [FXN].

On our Q2 earnings call just a few months ago, we did call out that July TPV growth for branded checkout was 8% [FXN]. We also said on that call, there were some comments made that suggested our expectation was in fact that we would be accelerating from there. That just simply did not happen.

We saw the growth moderate on branded TPV [FXN] through Q3 and now again we're pretty stable. We wouldn't call out any major change in the demand environment. The strength that we saw in July really was broad-based. I wouldn't call out anything different than what you heard from us, which is overall based on all the pieces that we're seeing, we think we're really holding share.

That doesn't mean we're holding share in every market. Some markets clearly were doing better than others. I wouldn't call out any real change in what we're seeing overall in our branded checkout experience. The trends are healthy. Clearly, we want them to accelerate. You've heard a lot from us about the initiatives we have and that we're executing against to continue to see stronger performance there.

I really would go back to some of what John Kim [our Chief Product Officer] talked about [at our] June [8th management meeting] around taking friction out of the experience, around improving latency, around really making our branded checkout experience as upgraded as possible.

On top of that, giving people more ways to use PayPal and making it a much more valuable and rewarding way for people to pay. Those initiatives really continue. I think the work that's being

done now is much more about improved focus and clarity. This really needs to be invested in in a very meaningful way to advance ourselves. And that's how I would think about it.

Colin Sebastian

Okay. But the core product enhancements are going to be the same as what John and the team outlined at the investor event?

Gabrielle Rabinovitch

Yes. I'm not going to today call out new core enhancements to the branded checkout experience.

Colin Sebastian

Okay. Thank you.

Gabrielle Rabinovitch

Yes. You bet.

Operator

Your next question comes from the line of Ashwin Shirvaikar from Citi. Please go ahead. Your line is open.

Ashwin Shirvaikar

Hey, thanks. I wanted to ask about non-transaction OPEX [operating expense] and the prospect for the trend for that looking ahead. What's left in terms of the ability or the potential to keep pressing that? I think in the past you commented that next year is also going to down [in terms of year over year growth]. Any comments on non-transaction OPEX?

Gabrielle Rabinovitch

Yes. Ashwin, good to catch up. You heard Alex on the call. He took a question on the main [Q3 earnings] call about OPEX and how he's thinking about OPEX. He also made some comments in his prepared remarks about seeing the continued opportunity to drive more operating leverage while still investing in our key focus areas. We're not going to give guidance on this call about what we expect our non-transaction-related operating expenses to do next year. As you know, this year we'll be down about 10% [on non-transaction opex growth year-over-year]. That contemplates a decline in the mid-single digits in Q4.

We see a lot of opportunities to continue to operate more efficiently, even with what you saw today that was announced last week, the divestiture of Happy Returns. As we make these decisions around prioritization and focus, there are benefits that we see on the cost side in terms of how we think about running the business.

At the same time, there are important areas where we need to invest. I think Alex and Jamie are going to start working through what that right balance is, and I'd expect an update on that on our next earnings call.

But we certainly have not guided next year right now. I would say we see continued opportunity to drive meaningful leverage, but not in a position to give quantitative guidance today.

Ashwin Shirvaikar

Understood. And if I can ask about the credit net charge-offs, reserve build, those lines, what the expectation should be with regards to both the net charge-offs and the reserve build or release. What are the things that drive the release piece? The charge-offs I understand, but I'm just looking for the trend in charge-offs?

Gabrielle Rabinovitch

Yes. We built up some provision in the first part of the year, in part driven by the deterioration of our PayPal business loans portfolio. We've commented on how we very meaningfully tightened originations. The overall balance is down about 30 percent sequentially. As a percentage of the total portfolio, PayPal business loans a year ago was about 21 percent of our overall credit receivables and today it's about 12 percent. And so we've tightened originations. We've provisioned what we think is appropriate for the expected performance of that book. We do expect to see charge-offs continue to run through. I'd expect to see that condition persist.

That said, I think we believe we're adequately provisioned. You saw reserve coverage tick up just slightly in the quarter [sequentially]. That really was much more based upon the overall size of our portfolio declining, in part because of held-for-sale accounting related to the sale of [European buy now, pay later receivables to] KKR.

I don't know that I'd call out any meaningful change in our overall credit portfolio. Obviously, we're watching the consumer very carefully. We continue to expect to see normalization in the environment. But I think from a provisioning standpoint, we feel like we've adequately provisioned for what we're seeing in the business loans portfolio.

Ashwin Shirvaikar

Okay. And if I can just quickly say, thank you. It's a tremendous job you did over the last six quarters in the CFO spot. I just kind of had to say that. So thank you.

Gabrielle Rabinovitch

Thank you. I appreciate it.

Operator

Your next question comes from the line of Sanjay Sakhrani from KBW. Please go ahead. Your line is open.

Sanjay Sakhrani

Thank you. Gabrielle, I was trying to think about what level of branded growth gets the transaction margin to change. I'm not sure if that's the way to think about it. But with Braintree growing as fast as it is, how should we think about the type of growth we need to see in branded to get the transaction margin to turn?

And then to follow up on that first question that was asked, when you look [at] the proxies that you look at for e-comm growth over the last few months, [do] you guys feel like your growth was consistent with that for branded?

Gabrielle Rabinovitch

Yes. On the branded side, I'd say we think our growth was consistent. There are a lot of different data sources out there. We really look to triangulate across the whole group. Obviously we know what our markets are and we know what our addressable volumes are. We really did not see any change in the way we were showing up.

Overall, branded checkout performance has been pretty consistent and pretty healthy through the year.

As it relates to transaction margin and branded, it's a great question. I think it's also important to recognize, though, that the pressure that we've seen on transaction margin dollar growth is not from branded. The bigger pieces of the transaction margin dollar pressure is some of these lapping and transitory factors that we've called out over the past few quarters. Clearly we want to see stronger performance on our branded checkout. But without those lapping factors and transitory factors, you'd actually see a different trajectory on transaction margin dollar growth.

And so I'm not sure that I would think about that, it is a certain level of branded checkout that we would need. What we really need is to get past some of these grow overs on the transaction margin side and have a cleaner compare. That would certainly help.

Sanjay Sakhrani

Okay. Just one follow-up question. Alex talked about like tech consolidation as being one of the drivers. I'm just curious how that compares to the consolidation you guys already did. What does he mean by that?

Gabrielle Rabinovitch

I think with a company of our scale and age, there are always opportunities for more consolidation on the tech side. I would expect to see more of that. There is ongoing work that Alex has inherited that has been in process. We've made certain improvements in terms of consolidating our technology platforms over the past few years. You heard Dan talk about them and some of the work that was done. But we are no means finished with that work. There's a continuous process around it.

I'd say specifically on the data side as we think about how we continue to harness our data in a better way to inform better programs and more relevant experiences for our consumers, consolidation there on the tech side is quite important.

Sanjay Sakhrani

Okay. Great. Thank you.

Operator

Your next question comes from the line of Dan Perlin from RBC. Please go ahead. Your line is open.

Dan Perlin

Thanks. Hey, Gabrielle. I just wanted to ask more of a clarification question. I probably missed it. But the transaction margin commentary that you gave for the fourth quarter, I think you said it will improve in the profile. I wasn't really sure what you meant by that. Are you saying that the transaction margin percentage is going to be better? Or are you saying like the absolute dollars?

Gabrielle Rabinovitch

Yes. Dan, I'm sorry I wasn't clear on the call. Really, all I meant to suggest is that in the third quarter you saw transaction margin dollars decline about 3.5%. Our expectation in the fourth quarter is that while transaction margin dollars continue to decline year on year, the decline is less severe. And so, in fact, the profile improves. It is less negative. That was all I meant by that comment.

Dan Perlin

Yes. So, then the two components of that, transaction expense, I'm assuming that could tick up a little bit in the fourth quarter relative to third quarter as a percentage of TPV. And then trying to figure out the loan loss in the fourth quarter with the KKR portfolio sale, if that's messing with that number a little bit. Sorry.

Gabrielle Rabinovitch

Maybe we just talk about the components of it. On the transaction expense [TE] side in Q3, we were at 93 basis points as a rate of TPV. That was an improvement of one [basis] point from Q2. As you know, in Q4, we always see a little bit of a seasonal uptick in our TE rate. I would expect this year to be the same, especially given some of the volume mix that we expect.

Given that volume mix around the branded side of things as well as the expectation on the PSP side, I'd expect our TE rate to move up from where we were in Q3.

On the transaction loss and loan loss side, I'd expect stability. I wouldn't expect a meaningful change there. That's how I think about those components.

Dan Perlin

Okay. That's awesome. And thanks again for all your support over the years. I really appreciate it.

Gabrielle Rabinovitch

Yes. You bet.

Dan Perlin

I appreciate it.

Operator

Trevor Williams from Jefferies. Please go ahead. Your line is open.

Trevor Williams

Great. Thanks a lot. Hey, Gabrielle, I wanted to go back to the transaction take rate. I know the decline, you're saying about 70% of that was on those same transitory factors you guys laid out last quarter.

Of the other 30%, can you give us a little bit more detail on how much of that is mix between branded versus Braintree or then the mix within branded or Braintree? I think you talked about branded, there's still a higher mix of large enterprise. So, like for like branded is a little lower year over year. But of the non-transitory factors, I'm wondering if you could just kind of size mix between branded and Braintree or the like or like comparison would be helpful. Thanks.

Gabrielle Rabinovitch

Yes. I wouldn't call out any like for like merchant pressure on the branded side. Branded did come down and it was a driver of the decline. So, the 30% that was not due to some of those transitory factors, an important part of that was due to branded decline. But that really is sort of merchant mix oriented and geo mix oriented and it's not like for like merchant pressure.

Trevor Williams

Understood. Sorry, that was poorly phrased. I was thinking branded in aggregate, lower take rate year over year, Braintree aggregate. Okay. But understood.

With the mix headwinds though within that, would you say that there's anything that looks like it could be more structural with markets where you've maintained or improved share more recently where you think kind of structurally might grow faster that are lower take rate? I'm thinking maybe pockets of Europe like Germany, or if this is truly transitory with mixed can ebb and flow over a couple of quarters between large enterprise and SMB [small-to-medium businesses] and over a long run, we're expecting stability. Thanks.

Gabrielle Rabinovitch

Yes. So, some of what we've done and how we've moved forward with some of our largest enterprise customers is resulting in some nice wins on volume. Those will come to us with a lower take rate. We've also done well with some newer merchant relationships that sit in geo[ographies] outside the US and that too will have a take rate implication. I don't know that structurally I see a change in our business. I think we have a number of initiatives that over time could help contribute to healthy growth and good performance on the yield side.

But some of these things are counterbalancing. We've talked about how our P2P business has accelerated a bit and how important P2P [peer-to-peer] is. If we saw P2P re-accelerate, that would actually negatively affect our take rate. At the same time, if we start to see PPCP [PayPal Complete Payments] start to really ramp and we actually see PPCP start to take incremental volumes and Braintree slow a bit at the same time, that would be beneficial to that overall take rate dynamic.

We don't guide take rate, but we can talk about some of the trends that we've seen in the quarter. But there's nothing right now I would call out structurally around persistent pressure there. Maybe just one thing I would call out though, we have talked about all year some of this migration and degradation of certain platforms like PayPal Pro unbranded business, that has put pressure on the take rate as well. As we are moving towards PPCP and we're seeing some of those PayPal Pro volumes come off, that has negatively affected that take rate performance too.

Trevor Williams

Got it. Okay. Thank you.

Operator

Your next question comes from the line of Tim Chiodo from UBS. Please go ahead. Your line is open.

Tim Chiodo

Great. Thanks a lot for taking the question. On branded checkout, the number was roughly 6% FX neutral [TPV] growth for the quarter. I apologize if I missed it, but did you or would you, if you're willing to give just directionally whether the US was roughly in line with that number or slightly faster or slightly slower?

Gabrielle Rabinovitch

Yes. So, we have not broken out US versus ex-US. What I would say is generally the trend this year has been very consistent. So, what we're seeing underneath that global branded number between US and non-US has really not shifted.

Tim Chiodo

Okay. All right. Great. Thank you. And the follow-up is on, and Gabrielle, you just mentioned it on PayPal Pro and how that's pressuring to an extent. The migration there, I believe last quarter you gave a stat that about 5 billion of volume had been successfully migrated. And to your point, there's an assumption that some other small portion might have left the platform or unsuccessfully migrated. Can you give some context on how much more progress has been made and roughly or directionally how far into that migration process we are?

Gabrielle Rabinovitch

Yes, sure. And I wouldn't think about PPCPs addressable market or global opportunity being the old PayPal Pro business. I think the first place to start is that historically we've really never stood up a really competitive solution and market for that long tail of SMBs or channel partners as it relates to the unbranded processing side. I wouldn't think about the opportunity being just switching over. This is really going after a very large addressable market of SMBs and channel partners globally. We're already in the US, we're already in parts of Europe, we're expanding into Australia. This is a business that we feel very strongly about in terms of our right to win. The PayPal Pro migrating over is certainly a component of what we're looking to do, but that's not the go-to-market. That's a portion of the go-to-market strategy.

I'd say overall, the team is very pleased right now with what the pipeline looks like. It's built out very nicely. We will be doing implementations through next year and those volumes will be growing nicely. And importantly, the feedback we've gotten about the quality of the product and the solutions that we're bringing to market has also been very, very solid. All indications are that this is moving in exactly the right direction.

I just wouldn't get stuck on thinking about this just as we've got this pool of PayPal Pro volumes and they're migrating over. Because remember, the vast majority of PayPal Pro volumes historically were eBay volumes. That was the platform that eBay volumes were processed on. We really actually had very minimal penetration of our SMBs as it relates to unbranded volumes on PayPal Pro.

Tim Chiodo

Excellent. Thank you for that.

Gabrielle Rabinovitch

Yes, you bet.

Operator

Your next question comes from the line of Andrew Jeffrey from Truist Securities. Please go ahead. Your line is open.

Andrew Jeffrey

Hi, I appreciate you taking the question, Gabrielle. I'm wondering, Alex called out pretty impressive PSP share and we've talked a lot about the dynamics of what that means for take

rate and for transaction dollars. I'm wondering if you could talk a little bit about the competitive environment. Obviously, a big PSP competitor has cited pretty aggressive pricing or I guess heightened switching in the US. Heard some commentary about perhaps PayPal, Braintree being pretty aggressive on price. Can you just characterize the competitive and pricing environment within that enterprise PSP business?

Gabrielle Rabinovitch

Yes. I don't know that I would call out major changes from the way we're seeing that environment. The US is competitive. Our capabilities have improved very meaningfully on the Braintree side. Others' capabilities have improved as well. But I'd say from an authorization rate standpoint, we feel like we are absolutely best in class. That informs the way we think about how we market and what we do on pricing.

Every pricing negotiation is different. The set of products and services we bring to merchants is different depending on where they sit, what geography they're in, what vertical they serve. I don't know that any pricing negotiation is the same when you're talking about these very, very large enterprises. We've obviously taken some nice business from a number of different competitors in the space over the past year and we're proud of that. I think the way Alex described it is we've now developed a beachhead. Going forward, we'll think carefully about some of those relationships. We feel very good about what we've accomplished in the market.

But the other areas where we're leading, and it's coming through in the volumes that we're getting from these large enterprises, is how we're serving them. I would say the way we think through account support and account management and how integrated we are into some of our merchants' operations has also been distinguishing and differentiating from some of the other competitors.

I think the US is more price sensitive and there we've negotiated and we've taken the business that we think is important for us to continue to grow our share. But I wouldn't call it any major changes.

Andrew Jeffrey

Okay. And given, and I've heard you talk about your view before that PayPal and Braintree have very competitive conversion rates. Is there room to significantly improve conversion rates in a manner that that helps Braintree monetization? Is there any sort of timeframe over which we might think about that happening?

Gabrielle Rabinovitch

You cut out just a touch. Did you ask if we could improve authorization rates further and then use that in how we think through those merchant relationships? Could you just clarify, Andrew? I'm sorry.

Andrew Jeffrey

Yes, I was just asking if there's a means to improve authorization rates more and whether or not that is a realistic lever for driving better yield and better price realization in Braintree.

Gabrielle Rabinovitch

I think it depends on the relationship and on the market. I don't know that that would be the lever with some of our customer relationships. I do think auth[orization] rates will continue to improve over time, right? Because the way we use data continues to improve over time. I think auth rates will improve over time and will continue to get better. We'll get better with APMs [alternative payment methods]. We'll get better in additional markets. We'll get better in certain verticals where we have less experience. I think all of those will come to bear.

Where we see opportunity on the Braintree side is really in some of these value added services that we think are quite critical to differentiating our stack going forward. That's an area of focus. You've heard us discuss it before. There's some important value added services that we don't offer today. Some of the ones we do offer today can be better integrated into our core Braintree experience so that it's easier for customers to take those products and really benefit from them.

Andrew Jeffrey

Okay. Look forward to hearing more on that.

Gabrielle Rabinovitch

Yes. You bet.

Operator

Your next question comes from the line of Paul Golding from Macquarie Capital.

Paul Golding

Thanks so much, Gabrielle. Just wanted to ask you, we heard Alex on the call talk about seeking customer growth and also just growing the SMB business. And so I was just wondering structurally as we think about some of the OPEX, how you're thinking about balancing things like sales and marketing expense with having to go out and acquire customers again or acquire SMBs, which is obviously more one-off than getting large enterprise volumes through a single deal. Thanks so much.

Gabrielle Rabinovitch

Yes. I would actually say our gross organic ads in our business are actually very healthy. From a customer acquisition standpoint, I feel very good about what our prospects are. What you're seeing this year in terms of the reduction in customer accounts, in this quarter I think customer accounts were down about 2.8 million [sequentially]. Those are really core PayPal accounts in markets where we have meaningfully deprioritized our efforts.

We've pulled back on customer acquisition spend in parts of Latin America and Southeast Asia. As a result, we've seen this churn happen through this year. That's really what's driving that reduction in accounts. If we just look at our growth ads and the healthy top of the funnel, I think we feel very good that we have plenty of resources and capacity to continue to invest in the right places and that that will benefit us over time.

Paul Golding

Great. Thanks. And on the SMB side, just in terms of acquiring those merchants, those efforts obviously different than the enterprise side. How should we think about that given the step down we saw in sales and marketing expense in the quarter?

Gabrielle Rabinovitch

Yes. Sales and marketing expense has been a source of leverage all year. Our sales and marketing dollars grew very rapidly through the COVID period. We were doing a fair amount of customer acquisition through incentives and other programs in some non-core markets. We very meaningfully pulled away from that. That's really most of that decline in the dollar growth.

On the SMB side, we have a strong go-to-market strategy for SMBs that we've been operating with for many, many years. We have a long tail of about 35 million merchants and the vast majority of those are SMBs. These days, if you compare today relative to probably 10 years ago, a lot more of that is also based on how we work with channel partners and how we think through those relationships. We have a very healthy ecosystem relationship with channel partners around how we serve them and how we serve their end SMBs. Then we also just have a good go-to-market strategy on the SMB side that has continued and is one that we've continued to focus on.

I think with the size of our organization and the areas where we are prioritizing, we should have plenty of resources to put money to work in the right ways.

Paul Golding

Great. Thanks so much.

Gabrielle Rabinovitch

Yes.

Operator

Your next question comes from the line of Ken Suchoski from Autonomous Research. Please go ahead. Your line is open.

Ken Suchoski

Hey, good evening, Gabrielle. Thanks for taking the question. I just wanted to ask about Braintree. Our understanding is that Braintree is mostly a US and UK business, obviously two big

markets for PayPal. But I think last quarter, the team talked about expanding Braintree into Europe. So can you just give us an update on the progress there and how you're feeling about winning in that market?

Gabrielle Rabinovitch

Yes. We feel good about how we stand up with LEs [large enterprises] in all the markets in which we compete from a Braintree standpoint. We've done well in Europe. We've done well in the UK. We've also obviously done quite well in the US. We've had merchant wins in other geo[graphie]s too for Braintree.

It'll continue to be a focus. When you look at the growth in our international TPV, which had very healthy growth in the quarter, some of that was attributable to growth in Braintree that was ex-US. That will continue to be an area of focus for us.

Ken Suchoski

Okay, great. And then in terms of pricing to value, and some of the comments that Alex made on the public [Q3 2023 earnings] call, I think the team at the June management meeting noted that some of the value-added services will take a little bit of time to roll out. So can you just remind us, I guess, particularly as it relates to larger enterprises, what are those value-added services you're currently offering and what the additional offerings will be throughout next year? Thank you.

Gabrielle Rabinovitch

Yes, so today we offer payout services, risk services, chargeback protection services. Those are some of the major service areas where we offer value-added services for Braintree specifically.

We did call out in June that we would be introducing FX as a service. We don't have an update on timing for that. With a new CEO, all of these initiatives are being looked at. I think timelines will be discussed as Alex starts to put out what his plan is.

I'd expect more detail and kind of roadmap and pipeline of product enhancements as we get into next year. But today we do offer a healthy set of value-added services. I think I commented on this a few minutes ago. I think there's also an opportunity to better integrate some of these value-added services so they're part of one stack. That also is important for merchants because they don't want to have to do multiple integrations for different pieces.

We have room to do better on the value-added services side. We have room to introduce higher-yielding value-added services, which will support the business. On the PPCP side, we're launching with these services which is quite helpful because it's allowing us to build out a really nice pipeline and it's helping our go-to-market strategy.

Ken Suchoski

Great. All right. Thanks, Gabrielle.

Gabrielle Rabinovitch

Yes, you bet. I think that's all the time we have. So thank you for your questions. We'll look forward to catching up over the next few days. You know where to reach us. We look forward to connecting soon. Krista, I think that's all we got.

Operator

This concludes today's conference call. Thank you for your participation. And you may now disconnect.