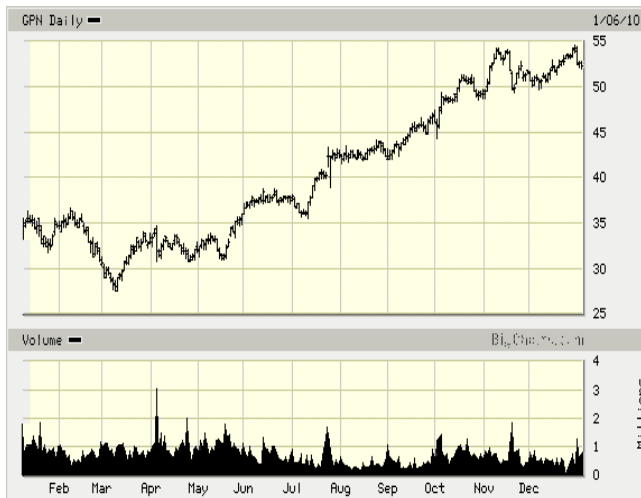


Technology Research Group

α Forensic Accounting & Equity Research Expertise α

Global Payments (GPN - \$49.20)



January 8, 2010
Analyst: Chris Bulkey
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Invst Rating: Sell
Price Target: \$42
FY End: May

Year	Revenue	EPS	Cash Flow
FY06	\$908M	\$1.53	\$235M
FY07	\$1.06B	\$1.75	\$191M
FY08	\$1.27B	\$2.01	\$272M
FY09	\$1.61B	\$0.46	\$383M
FY10E	\$1.59B	\$2.36	\$391M
FY11E	\$1.73B	\$2.11	\$322M

*Accounting Far From Conservative, Outlook Disappointing
Reiterate "Sell" Recommendation*

~ Earnings Report ~

Global Payments reported revenue and pro forma net income of \$408.95 million and \$0.71 per share for the second quarter of fiscal 2010 (TRG estimates - \$411M and \$0.59). Top-line growth remained in deceleration mode. Operating profit was little changed (as a % of sales). Cash flow was a glaring red flag. DSOs were partly to blame. Unusual recognition of settlement processing obligations exacerbated the problem.

Guidance for the remainder of the year disappointed. Aggressively managing this latest quarter jeopardized run rates for the second half. We believe estimates still have downside risk. Another foray into unprofitable territory cannot be ruled out (though probably not a serious risk until 1HFY11). Investors are voicing displeasure. Shares are moving lower in response.

Performance Measures

The following table summarizes P&L indicators from the most recent quarter (F2Q10), the previous quarter (F1Q10), as well as the year-ago quarter (F2Q09). Metrics are GAAP-based unless stated otherwise.

<u>Metric</u>	<u>F2Q10</u>	<u>F1Q10</u>	<u>F2Q09</u>
Revenue	\$408.95M	\$441.3M	\$365.9M
GAAP EPS	\$0.71	\$0.71	\$0.57
Pro Forma EPS	N/A	N/A	N/A
Operating Margin	21.69%	20.99%	21.29%
Tax Rate	27.8%	30.0%	26.7%
Return on Equity *	24.9%	27.9%	27.1%
Days Sales Outstanding	29 days	26 days	25 days
Inventory	\$12.9M	\$13.3M	\$6.6M
Cash Flow **	\$88.7M	\$696.5M	\$132.7M
Shares Outstanding	82.2M	81.3M	81.2M

* ROE is annualized with the net income run rate and quarter-end S/H equity balance.

** Measured as cash generated from operating activities.

P&L Unstable

- Top-line growth in deceleration mode (12% Y/Y vs. 30% in F2Q09).
- Operating margin improvement (up 1.8% Y/Y in basis points) inadequate relative to volume gains.
- Inability to expand operating leverage especially worrisome; restructuring measures and/or asset impairments inevitable.
- Last round of serious cost cuts enacted in F3Q09; loss of profitability overlooked (i.e., no sell-off following earnings press release); leniency unlikely to be extended again.
- Tax rate closer to 28.9% (vs. 32.0% Y/Y) including non-controlling interests.

- Return on equity overstates sustainable growth (ROE x Retention Rate = .249 x .972 = .242 using F2Q payout ratio).
- Net income inflated by previous expense reductions, insufficient valuation allowances, lenient tax rate (with non-controlling interests), and reduced costs from check guarantees/loss reserves.
- S/H equity diluted by unfavorable paid in capital/retained earnings progression.

Financial Reporting Suspect

- Doubtful accounts allowance highly uncorrelated with receivables; contra account reductions in FY09 and 1HFY10 reflect poorly on credit policies and earnings quality.
- Increase to obsolescence reserves well below inventory spike (inventory up 117% YTD, allowance up 17% and only 6% of corresponding asset balance).
- Expenses related to check guarantees down 39% YTD; loss reserve up 5% (utilization and adjustments appear to be far outpacing additions).
- Elevated payments smooth expenses and accelerate income; under funding reserve could put credit worthiness and solvency levels at risk.
- Change in fair value related to non-controlling interests highly variable; discount rates applied to “present value of future earnings” warrant scrutiny.

Valuation and Recommendation

Shares are up 65% YTD and valued at 127 times trailing GAAP earnings. Loose comparable Fidelity National Information Systems (FIS, not rated) trades at roughly 24 times. A loss of profitability in F3Q09 inflated Global Payments' appraisal. Corresponding writedowns paved the way for ROE to show improvement thereafter. The quarter preceding expense reductions provides a more realistic indication of sustainable growth.

In F2Q09, ROE times Retention Rate approximated 17.4% (vs. 24.2% in this latest quarter). Going forward, we believe this estimate has more downside risk than upside potential. Another disappointing quarter could accelerate volatility. A harmful governance-related matter (i.e., restatement of previous results) could have disastrous consequences. We reiterate a “Sell” rating on Global Payments. We are lowering the price target (to \$42 from \$46) for downside toward previous expectations (assumed multiple goes to 20 times forward earnings from 22 times).

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