January 5, 2012

INVESTMENT LETTER

How MasterCard Incorporated (NYSE: MA) and Visa, Inc. (NYSE: V) are Driving Cash Out of Business

Part One of Two Parts

INTRODUCTION

The writer experiences the convenience and the seductive power of the credit card when he dines under the Golden Arches, and now has a better understanding of why people use a credit or a debit card at McDonald's where, on average, the bill comes to less than six dollars per person per visit.

****

Plastic's challenge to cash as payment medium for food and drink at McDonald's is no isolated development. All around the world, from Santiago to Beijing, and in thousands of places in between, American Express (NYSE: AXP), MasterCard and Visa (the Big Three) are flexing their muscles, taking the fight to cash, and pushing cash against the ropes in a fierce, twenty-four hours a day contest for market share in the global payments industry.

> I term American Express, MasterCard, and Visa the Big Three because together they control much of the credit and debit card markets. (See Table I on page two). American Express of course is a fine company, but because MasterCard and Visa target a wider demographic and have more merchants in their network, I believe that these companies will enjoy growth superior to what American Express will experience, giving them greater investment potential. I will use MasterCard and Visa interchangeably as they are similar in what they do and how they do it.

****

It was 6:45 on a Thursday morning in January 2011. My swimming team's workout at the St. John Health Club had started at 5:30 a.m. and it was now over. I had taken a shower and I was beginning to get hungry. I remembered that it was nearing the end of the month and that early in the year I had decided to give myself, as a reward for staying with some New Year's resolutions, a monthly treat of uncompromised self-indulgence, a reinforcement for overcoming bad habits, starting good ones, and for improving dedication to discipline.

So far in January I had not had my reward but I sensed that this was the day I would enjoy it. It was time for breakfast and what better monthly reward could there be than some pancakes with butter and syrup?

It was still too early for many restaurants to be open but I knew there was a McDonald's one and three-tenths mile and five and a half minutes from the St. John Health Club where the swimming workout had taken place, and I knew that the dining room at the Golden Arches would be open and that it would not be too busy, making it possible for me to study while I had breakfast.

It was not a long drive to McDonald's, but it was still early and quiet, giving me a few moments to think, especially about the business of MasterCard and Visa. For a week I had been looking at the 10-K forms that MasterCard and Visa had filed with the Securities and Exchange Commission, forms that covered their last five fiscal years of operations.

Table I

Free Cash Flow of Visa Inc. (NYSE: V)

For Fiscal Years Ending September 30.

All numbers in millions of United States dollars.

	2008	2009	2010	2011
Funds from Operations	3,869	3,820	5,026	5,906
less				
Capital Expenditures	415	306	241	353
less				
Dividends	93	318	368	423
less				
Repurchase of Common Stock	13,446	2,646	1,000	2,024
Equals				
Free Cash Flow	23	(66)	2,082	3,096

Within the 10-K for each company I had paid the greatest attention to three reports: Net Income, Statement of Cash Flows, and the Balance sheet. I knew that both companies were immensely profitable, that they produced enormous returns on their investments, but I wanted to dig deeper and sharpen my understanding of what the financial statements implied about each company's competitive position.

While I was thinking about the battle that the Big Three were waging against cash, the traffic light at Peoria and 15th Street turned green and I made a left turn into the parking lot of the Golden Arches.

After exiting my car and walking into the restaurant, and with my wallet in hand, I approached the counter. I was ready to pay cash for my meal but before giving my order I noticed a machine prominently positioned between the two cash registers. I thought I knew the machine's purpose but, to make sure, I asked one of the employees how the machine operated.

The employee explained that, if a customer desired to pay for any drink or food with a credit card or a debit card, one issued by American Express, Discover Financial Services (NYSE: DFS), MasterCard, or Visa, the customer could use the VeriFone Systems, Inc. (NYSE: PAY) machine, running his card through the device which would then facilitate authorization for the purchase. He assured me that if I were to use a credit or a debit card to pay for my breakfast, I would find the machine easy to operate.

I recalled that Visa had launched a global program in October of 2010 to make it easier for "face to face merchants" to accept a card for purchases under twenty-five dollars, without requiring a cardholder signature, personal identification number (PIN), or providing a receipt, unless the cardholder requested a receipt.

When Visa introduced the face to face program, the company declared that the program had "the potential to increase speed at the point-of-sale, enhance consumer satisfaction and deliver

To read the full Investment Letter, please email us at contact@ferimc.com or call (918) 743-5959. You could also fill out your contact information at http://www.ferimc.com/contact.html, we will contact you as soon as possible.