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WATCHLIST THE GLOBE AND MAIL

Western Union's fantastic economic moat

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Western Union is the global leader in retail money transfer services. Its 510,000 locations in over 200 countries and territories make it a convenient way for people to send money around the world.JOHN WOODS/THE GLOBE AND MAIL

I love simple businesses that do the same thing over and over again. Rinse and repeat. So you can understand my fascination with Western Union Co. – a firm that has been around since 1851. After its stock recently plunged by more than 30 per cent I decided to take a closer look.

Western Union is the global leader in retail money transfer services. Its 510,000 locations in over 200 countries and territories make it a convenient way for people to send money around the world.

Western Union's customers often don't have bank accounts. Many are migrant workers who use Western Union to send money home to support their families. To them, Western Union provides an essential service. This year the company will transfer over $80-billion (U.S.) and handle 225 million transactions.

Western Union's business is very asset light. The company has no receivables, earns very high returns on capital and generates about $1-billion of free cash flow each year. In short, it is a fantastic business.

Capitalism ensures that this great business attracts competitors seeking to gain a portion of Western Union's abnormally high returns. Unsurprisingly, new entrants continue to crowd into the space.

Despite this increasing competition, Western Union has managed to maintain its dominance. In fact, over the past five years the company has actually increased its market share from 15 per cent to 18 per cent. Its next closest competitor – MoneyGram – sits at about 6 per cent.

How has Western Union been able to maintain its leadership? I believe that it is because the company possesses a sustainable competitive advantage – an economic moat. The nature of its moat is threefold: a strong globally recognized brand, network effects and economies of scale.

Before someone hands over their hard-earned cash, they want to ensure that the person they are dealing with is trustworthy and efficient. Using a lesser-known albeit less expensive competitor is not an attractive proposition. Brand counts and as a result, Western Union prices its services at a premium.

Customers also need to get money to very specific places. Western Union's global network is nearly 80 per cent larger than its next largest competitor. And once a customer finds a solution that works, they tend to use it for their next money transfer.

Finally, only 35 per cent of the company's costs are fixed and once covered, each incremental transaction adds to the company's profitability. As a result of being the largest player, Western Union's cost per transaction is lower than its competition.

Despite increasing competition Western Union has acted rationally by reducing prices slowly over the years. Price decreases result in higher transaction volumes and ultimately higher revenue. But price cuts are made tactically – just enough to maintain healthy profits but also squeeze smaller competitors with higher cost structures.

In its third-quarter press release the company announced that its business was being hurt by compliance-related changes in a number of markets and competitive pricing pressures in certain corridors.

In response, management announced cost-cutting initiatives and its plan to reduce prices more aggressively in certain channels. As a result, earnings per share in 2013 are likely to be 10 to 15 per cent lower than the $1.64 that Western Union is estimated to earn this year.

I believe the 30-per-cent stock price decline to be an overreaction and purchased the stock for my Value Fund. The current price, around $12.63, represents about 8.5 times 2013 earnings for a great business with a 4-per-cent dividend yield. Money transfers are a growing business and I expect future earnings to be higher after 2013.

The company recognizes this as well and it has announced an increased share repurchase program. The $744-million current authorization, if fully utilized, would allow them to buy back 10 per cent of the company's outstanding shares at current prices.

Longer term, technologies such as mobile wallets will further pressure Western Union's business. However, the company recognizes this and has embraced it by launching its own competitive offering. I suspect that the transition will take many years given the company's target market.

As sure as night follows day, the analyst community downgraded the stock and their target prices after the price decline. To my mind, the 30-per-cent pullback in the stock price makes an investment in Western Union more attractive, not less so.