



## Why Payments Startups Fail

Eric Grover

**Low acceptance costs, convenience, and security aren't enough. As this global review of would-be PayPals and Visas shows, startups need a clear path to a mass of users.**

**W**ith the advent of mobile payments, we read almost daily about new payments startups. And this avalanche of startups follows a period in the history of electronic payments that had already seen vigorous entrepreneurial activity. The hard truth is, very few of those startups succeeded—and only a scant number of those emerging now will.

Retail payment networks must deliver value, be reasonably priced relative to value, sufficiently secure, and easy to use. But while all of that is necessary, it's not sufficient for success. Startups must also achieve critical mass with those making and receiving payments.

To see why this is the case, we'll take a look at a number of current payments initiatives, along with some from the recent past. While our examples are taken from markets around the world, the lessons we can draw from them are generally applicable.

First, though, it's important to recall what would-be payments systems are up against. Successful retail payment networks such as MasterCard Inc. and Visa Inc. are terrific businesses. Entrepreneurs must ask themselves what their ideas offer that networks like these incumbents don't. After all, when

it comes to payments, consumers and merchants are creatures of habit. To win them over, challengers must be compellingly better in some respect.

### **A Long Way to Go**

Many startups peg their ultimate success on lower acceptance costs. U.S. Sen. Richard Durbin's famous amendment, along with merchant litigation and lobbying, have put a spotlight on this issue as never before.

Lower costs for everyone in the payments value chain is a great idea. These days, though, regulators and retailer Goliaths obsess about narrowly defined point-of-sale transaction costs. Viewed holistically, offering the lowest cost does not necessarily equate with greatest payment-network value. Many new payments systems have offered lower acceptance costs. It's been a losing strategy.

In 2005, the *American Banker* trumpeted Wal-Mart accepting Debitman, a venture-backed card network charging merchants 15 cents per payment. It was predicated on retailers promoting issuance for 6 to 9 cents of interchange and providing cardholder rewards. Debitman, later renamed Tempo Payments, flopped because it didn't provide sufficient, much less

compelling, economics to anybody in the value chain.

Much-ballyhooed Revolution Money launched in 2007 and wooed retailers with a 0.5% merchant discount and superior fraud prophylactics. It boasted as its chief executive Jason Hogg, son of a former MasterCard chief executive, and blue-chip investors Goldman Sachs, Citigroup, Morgan Stanley, Deutsche Bank, and America Online co-founder Steve Case.

However, it never had a credible business model, much less a business. In 2009, Hogg abandoned the dream, selling Revolution Money (basically software and management) to American Express Co. for \$300 million.

To provide cheaper payments for retailers as well as consumer convenience, National Payment Card employs drivers' licenses as an account key and the automated clearing house network to debit demand-deposit accounts. While the network is still breathing, established networks haven't lost a wink of sleep.

Would-be PayPal slayer Dwolla caps transaction fees at 25 cents, also betting lower cost is the ticket to success. With 7,000 merchants, it has a long way to go.

### **Fool's Gold**

Across the pond, European Union regulators are experiencing cognitive dissonance. They want lower merchant-acceptance costs, and toward that end they imposed price controls on

interchange and jawboned Europe's leading commercial network, MasterCard, into reducing its fees.

Simultaneously, however, they have urged 24 banks to launch a system called Monnet to compete with MasterCard as well as Visa Europe. Why would banks invest billions of euros in establishing a new card network that would be regulated like a public utility?

Founded in 2007 by Dominique Buyschaert, Brussels-based PayFair attempts to win merchants' hearts with lower cost and become what the EU regulatory mandarins have pined for, a third pan-European network. But PayFair's hurdles are comparable to those of Debitman and Revolution Money.

In a similar vein, India's central bank is pushing banks to support a national network called Rupay, with debit interchange 40% lower than that of MasterCard and Visa. RuPay's head, A. P. Hota, says it aims for a 50% debit share and to introduce credit in 2015. Beyond nationalistic vanity, what's appealing about a domestic network that's less profitable by design?

In the not-so-distant past, Cybercent, Millicent, Netbill, and Peppercorn all attempted to solve the micropayment cost problem. But absent a dispute, the marginal cost of an electronic 50-cent payment and of a digital good is zero. Trying to compete in-between proved fool's gold. Moreover, MasterCard, PayPal, and Visa could slash micropayment fees tomorrow.

### **So What?**

How about security? Isn't this the golden ticket? As the data breaches at Global Payments and Heartland Payment Systems remind us, card-payment networks are not perfectly secure.

Let's look at the record. Chip-card-based Mondex, invented in 1990, proposed a more secure card system enabling value to be loaded, stored, and used on a distributed basis. In 1995 it debuted in Swindon, England. Marquee backers included NatWest,

Midland Bank, Wells Fargo, British Telecom, MasterCard, and AT&T.

But the problem Mondex tried to solve wasn't a big enough headache for either consumers or merchants. In 2001, MasterCard acquired the shares it didn't already own and buried Mondex.

CyberCash, Digicash, and First Virtual were all putatively safer than credit cards on the Internet. All failed. Notwithstanding fraud losses running 10 to 20 times higher online than in face-to-face situations, traditional card networks' ubiquity, familiarity, and good-enough security prevailed.

At the height of the dot-com bubble, venture-capital-backed Beenz

fail because they don't achieve critical mass in a relevant market.

Whatever the putative better mousetrap, new payment systems need a path to critical mass. Where existing systems work, this is difficult, albeit possible.

In his book, *Crossing the Chasm*, Geoffrey Moore counsels technology firms challenging dominant incumbents to conquer a niche before attempting to "cross the chasm" into the mass market. His advice applies to payment networks as well.

Neteller, Moneybookers, Deutsche Telekom's Click&Buy, and Wirecard's Click2Pay achieved limited success

## **The M&A Solution**

Networks can use acquisitions and consolidation to build mass quickly. Here are some prominent examples, with results both good and bad:

In the late '80s, the U.S. was a patchwork of 135 regional bank-owned debit/ATM networks. Most were rolled up into national networks such as First Data's Star. However, while PIN-debit networks achieved national footprints, their neglected brands withered and they now ride in the slipstream of MasterCard's and Visa's brands.

Rather than consolidate, some European national networks are attempting to establish pan-European interoperability through the EAPS coalition. Consolidation might be viable.

MasterCard acquired the ATM network Cirrus in 1988, and in 2002 it bought the Brazilian debit scheme Redeshop and Europay, which had just picked up the U.K. debit scheme Switch. Visa acquired the Plus ATM network in 1987 and debit network Interlink in 1991.

and Flooz basked in the limelight, raising \$80 million and \$35 million in capital, respectively, before crashing and burning in 2001. Beenz users earned and spent Beenz for performing various online activities. Flooz, preposterously, attempted to create a new online currency.

Then there's Pay By Touch. At its peak, 3.6 million customers could initiate payments with an intrinsically convenient and secure fingerprint at 3,000 merchant locations. Novelty aside, consumers' reaction was, So what? Pay By Touch burned through \$300 million before going belly up in 2008.

### **'Crossing the Chasm'**

While payment networks must be cheap and secure enough, cost and security are not why payment networks fail or succeed. Networks

serving niches such as online gambling, but never crossed the chasm.

Early general-purpose card networks such as Diners Club, Hilton's Carte Blanche, Air Canada's En Route, and AmEx all focused on the travel-and-entertainment market. Hilton pulled the plug on Carte Blanche in the 1980s. Air Canada sold En Route to Diners in 1992. Diners languished as a T&E and corporate card network before being acquired in 2008 by Discover Financial Services, which was seeking to boost its overseas presence.

Meanwhile, AmEx dominated T&E and expanded into and achieved critical mass in the general-purpose payments market.

Similarly, PayPal emerged triumphant from the competitive maelstrom of person-to-person payments. It followed Moore's crossing-the-chasm model,

dominating proprietary e-auctions before expanding into general-purpose e-commerce payments. Now PayPal is taking the logical next step: establishing physical POS beachheads.

In a similar vein, Alipay and MercadoPago are building mass by serving e-auctions in Asia and Latin America, respectively.

The most successful strategy for building critical mass has been partnering, perhaps best exemplified by MasterCard's and Visa's global contractual web of tens of thousands of banks.

Recognizing this, closed-loop networks AmEx and Discover opened up, rightly calculating that sharing economics with partners to reach more consumers and merchants is worthwhile.

Discover, which got a running start by leveraging the proprietary credit card portfolio held by its founder,

Sears, is on the brink of U.S. acceptance parity with MasterCard and Visa, thanks to partnering. Indeed, to extend its overseas footprint, it has struck acceptance-reciprocity deals with JCB, Bank & Credit Card, China Union Pay (CUP), and the nascent RuPay.

Venture-capital-backed Bling Nation distributed its nifty mobile-phone based debit system through clusters of community banks in small towns. And PayPal even entertained Bling as a path to the physical POS. But Bling hit the skids because it lacked capital, distribution, and an irresistible value proposition to overcome consumers' satisfaction with existing payment cards, electronic bill pay, checks, and cash.

Still, enormous consumer and/or merchant reach isn't a guaranteed road to network critical mass. Reigning search gorilla Google Inc.'s online payments foray, Google Checkout,

underwhelmed and has been folded into Google Wallet.

In 1999, what was then the leading search network, Yahoo, with Check-Free, launched a bill-payment service. The following year, with HSBC, it launched P2P PayDirect. Those joint ventures called it quits in payments in 2007 and 2004 respectively.

Three of America's largest banks, Citi, Bank One, and Wells Fargo (which partnered with eBay), introduced P2P payment systems called C2IT, eMoney-mail, and Billpoint, respectively. After several years, they threw in the towel.

One more example: There are more than 5.6 billion cell phones worldwide. With more than a billion subscribers, Vodafone, Orange, T-Mobile, and Telefónica Móviles attempted to build a mobile-operator-centric payment network called SimPay. It folded in 2005. SimPay lacked

an acceptance network, had unrealistic pricing expectations, and offered nothing to wow consumers.

### Network Effects

In emerging markets the opportunity is different. In Kenya, where risky and inconvenient cash is the primary retail payment system, card issuance and acceptance are weak. Few are banked, but mobile-phone penetration is high. Mobile-phone based M-Pesa leaped into the breach, and today, with 14.9 million users and 32,000 agents, it is Kenya's largest retail payment system.

Critically, the central bank took a light regulatory approach and refused banks' request to block M-Pesa.

Bill-to-carrier networks Boku, Mobipay, Payfone, and PaymentOne enable consumers without traditional payment cards to buy digital goods. They're not trying to be low-cost. Merchant discounts run 12% to 18%.

Whether mobile-phone payment networks can establish multinational and full-spectrum (e-commerce, m-commerce and physical POS) footprints remains to be seen.

Also, network effects are powerful. While the lion's share of payments is domestic, free-to-compete multinational payment systems beat national systems.

Notwithstanding China's 2001 World Trade Organization commitment to open its domestic payments market by 2006, China UnionPay continues to enjoy a protected monopoly in the world's second largest card-transactions market. In the hypercompetitive United States, Visa chief executive Joe Saunders would love to be similarly shielded from pesky competitors.

The Retail Council of Canada—a merchant lobbying group—had the chutzpah to ask finance minister Jim Flaherty to prevent MasterCard and Visa from competing in debit, which would have suited Canada's largest payment network, Interac, just fine.

Europe's third-largest retail payments network, France's Carte Bancaires, enjoyed a domestic monopoly until 2009. That's when MasterCard motored around the French banking cartel's Maginot Line, striking issuance deals with retailers Carrefour and Auchan without Cartes Bancaires.

Poland abandoned the Polcard debit network more than a decade ago. More recently, Dutch and Finnish banks shuttered their national debit schemes PIN and Pankkikortti.

If government regulation doesn't smother it, the vibrant retail-payments-network industry will continue to attract entrepreneurs and capital. What this record shows, however, is that entrants should think critically about why their approach is superior and the viability of their path(s) to network critical mass. **DT**



**Grover: New payment systems survive by finding a pathway to critical mass.**

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