

Look Who's Going for Network Effects

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Acquiring processors haven't been thought of historically as platform businesses. But the industry is changing, and processors that do it right can achieve enviable valuations.

The Holy Grail for payments companies is to enjoy network effects and critical mass. Global networks such as MasterCard and Visa have both in spades. Most payments companies, however, don't.

The average revenue-valuation multiple for MasterCard and Visa is 11.1. By contrast, the average revenue-valuation multiple of payment processors First Data, Global Payments, Square, Total System, Vantiv, and Worldpay is 3.3.

Why the disparity? The merchant-acquiring and processing industry is hypercompetitive. It provides acceptance for credit and debit cards and other payment products to merchants, governments, and nonprofits. And the competitive bar is rising.

Acquirers with an edge in origination, services, catering to specific industries, delivery footprint, or scale, can be fine, sustainable businesses. But those that can develop network effects will be the gems.

The Catbird Seat

Historically, acquirers competed on price, often by concealing fees, and distribution. With large merchants, scale mattered. But not for millions of small merchants. The net merchant-discount fees Goliath retailers pay are thin gruel—three to five basis points. However, for mom-and-pop merchants, net merchant-discount fees can be 20- to 30-fold higher.

Notwithstanding higher origination and servicing costs, small merchants are the mother lode of industry profitability. The knowledge asymmetry between sellers and buyers, plus inertia, buoy higher fees. These lucrative processing fees, however, aren't sustainable for undifferentiated, standalone payments.

So a wave of innovation has hit the industry. Merchant acquirers are wrapping services around payments, exploiting nontraditional origination channels, offering marketing services, embedding themselves in high-growth e-commerce platforms, building multinational delivery, and aggressively cross-selling complementary services.

Acquirers are also stampeding to partner with or buy independent software vendors (ISVs) so they can embed payments in those services. Bundling payments with critical software produces stickier, and less fee-sensitive, merchant relationships.

Some acquirers have been at this a long time. Mercury Payments, acquired by Vantiv in 2014, has partnered for 16 years with hundreds of software suppliers and developers serving small merchants. More recently, Global Payments and Total Systems acquired ISV assets.

But acquirers must be mindful of who's in the catbird seat. ISV consolidation will squeeze payment-processor economics. With ISVs Revel and ShopKeep, for example, payment processors are already relegated to the back seat.

A Better Model

The better model for acquirers is to control the platform, offering their own and third-party software.

Take mobile-acceptance pioneer Square. With more than 2 million small and micro merchants, Square controls its software platform and has opened it to third-party developers. With a powerful brand, it has attempted, thus far unsuccessfully, to curate a proprietary branded ecosystem of merchants and cardholders. If it were to succeed, that would be a game-changer.

There are other examples. Point-of-sale terminal colossus Ingenico acquired payment processors EasyCash, Ogone, and GlobalCollect, vertically integrating into acquiring—a risky move, as acquirers are Ingenico's primary terminal-distribution channel.

The world's largest merchant acquirer and processor, First Data, also controls a platform. It sells a proprietary merchant point-of-sale system, Clover, with a library of its own and third-party software. When a merchant buys Clover, it becomes invested in the software, and, perhaps additionally,

uses First Data-sourced dynamic currency conversion, payroll, or credit card services.

That should reduce fee erosion and merchant attrition—endemic problems for acquirers serving small merchants. While it's early days, 300,000 shipments suggest First Data is starting to build a credible platform business.

Multinational acquirers are platforms of a different sort. Offering Visa, MasterCard, American Express, and Discover may suffice for U.S. cinemas selling tickets online, but not for e-merchants selling luxury goods, games, or software worldwide. A handful of processors specialize in delivering acceptance to multinationals and e-retailers selling globally.

Adyen and Worldpay, for example, provide more than 250 and 300 payment methods, respectively. Offering more payment schemes attracts international merchants, and more multinational merchants attract more payment schemes. There aren't likely to be more than a handful of global winners in this race.

Pearls To Watch for

The point is that processors with scale owning, or processing on, both sides of the network have opportunities to deliver additional services that increase in value with greater participation.

With its proprietary processing platform, ChaseNet, and its digital wallet, ChasePay, JPMorgan Chase is attempting to deliver closed-loop benefits to its merchants and cardholders, à la American Express and retail-card providers Synchrony and Alliance Data Systems. If it does, more merchants will beget more and more profitable cardholders and vice versa.

First Data could deliver a coup de théâtre, curating a platform of banks and retailers over which it supplies more robust promotional, rewards, and loyalty programs, and thereby generating growth and commanding richer economics. The best outcome for First Data would be where it is the bank-issuer processor, network and merchant processor, controlling the processing and economics at each step.

The bigger opportunity, however, lies in wrapping value around other networks' transactions, where it processes for the cardholder's bank and the merchant.

First Data has underperformed against its opportunity for at least a decade. From 2007 through 2015, it grew revenue at 4.5% per annum. In the same period, MasterCard and Visa purchase volume increased annually 6.7% in the U.S. and 8.7% globally. First Data trades at a discount to its peers. If, however, it can build compelling network effects, bolstering growth and unit economics, it's undervalued.

Hot e-commerce specialists Adyen, Braintree (PayPal), Stripe, and WePay benefit from network effects enjoyed by clients such as Airbnb and Uber.

In sum, in the growing, global, and ferociously competitive payment-processing industry, platform businesses with compelling network effects will be the pearls to watch for.

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