A Reckoning on Wall Street

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The payments market is enjoying more vitality and growth than most can remember. So what's behind the recent market rout?

The payments market is enormous and growing. Capgemini forecasts a 15% compound annual growth rate for global noncash digital payments through 2027. The Boston Consulting Group estimates global acquiring revenue will reach $100 billion by 2027, and total payments-industry revenue will be $2.2 trillion by the same year.

Low-cost capital, worldwide electronic payments growth, the one-time Covid boost, business models based on naturally increasing recurring revenue streams, intrinsic operating leverage, and the industry increasingly finding ways to add and charge for value around payments—all these factors turbocharged the flow of capital pouring into the sector, driving up valuations.

Investors wanted to believe in growth and that transaction and account economics are sustainable. Sometimes they are. The payments sector was hot until it wasn't.

As of Nov. 3, the S&P 500 was down 8.56% from its high. That's more than explained by a higher cost of capital and fears of a possible recession in 2024. Easy money inflates valuations and makes it possible for less-robust businesses to survive. From 2008 until 2022, the Fed's real benchmark interest rate was negative.

However, the reign of easy money is over. In October, the Federal Funds Effective Rate was 5.33%, while inflation in October was 3.2%. In The Wall Street Journal's most recent poll, 48% of academic and business economists surveyed forecast a recession within the next 12 months.

Plunging Processors

Market agita about the payment sector, however, is more severe. Paraphrasing Ernest Hemingway in The Sun Also Rises, we can say richly valued payments firms lost value gradually and then suddenly.

Many payment processors were priced to perfection, and beyond. Then the spell broke. Triggered by growth misses and reduced guidance, Dutch payment-processing phenom Adyen's and consolidator Worldline's stock prices experienced jaw-dropping one-day drops of 36% on Aug. 17 and 59% on Oct. 25, respectively.

Over the last several years, valuations across the payments industry have been devastated. As of Nov. 3, Worldline was down 86% from its high, Adyen 76%, Block 82%, Nuvei 88%, Paysafe 94%, Cielo 89%, PagSeguro 87%, Stone 87%, FIS 66%, Global Payments 53%, Nexi 67%, and Shift4 52%. A sector-wide collapse of this magnitude should alarm shareholders, management, employees, and customers.

Nose-bleed private-payments valuations have fallen as well. Last year, ballyhooed buy now, pay later network Klarna saw its valuation plummet 85% to $6.7 billion from $45.6 billion in 2021. Klarna demonstrated there's an enormous market for low-friction, short-term, often fee-free consumer credit. But that's not enough. Generating profits is necessary just to justify even its reduced valuation. In March 2023, high-flying Stripe raised $6.5 billion

at a $50-billion valuation, down 47% from its $95-billion valuation in 2021.

With pricier capital and a challenging environment, many of the more than 5,000 fintechs in payments won't survive.

Semi-open general-purpose payment networks American Express and Discover have weathered the storm somewhat better than the processors, and are only down 21.5% and 32%, respectively.

Icarus-like PayPal, however, lost its way and is down a whopping 81% from its apogee. Complacency, management virtue-signaling, and being characterized as, and acting too much like, a processor rather than a branded retail and peer-to-peer payments network are largely to blame. Building branded network mass abroad and at the physical point of sale would be the better bet to boost long-term profitable growth, and, therefore, enterprise value.

Venture and private-equity investment in payments has also declined dramatically. KPMG's "Pulse of Fintech H1 2023" reported that global fintech funding activity (venture capital, private equity, and M&A) crested in 2021 at 1,026 deals valued at $57.5 billion. In 2022, it ebbed to 878 deals totaling $56.3

billion. In the first half of 2023, fintech payments funding plummeted to 243 deals totaling $16.2 billion.

Risk…And Reward

Payments businesses need credible stories of sustainable, profitable growth. And they need to deliver. There is a range of not-mutually-exclusive approaches.

Being cheapest is rarely the best strategy unless you have other powerful levers with which to monetize payments. All merchants and financial institutions, all other things being equal, would like to pay less for payments. It’s a price-competitive market, particularly for large enterprises. Gargantuan merchants like Amazon and Walmart, financial titans such as Bank of America, Capital One, and Citi, and tech giants like Apple, all squeeze fees.

Small and mid-size enterprises and small financial institutions, however, pay vastly higher fees. So, notwithstanding costing more to originate and service, SME portfolios, if sticky, can be very attractive. But even there, software companies, marketplaces, and tech platforms are capturing an increasing share of transaction economics. Mobile-

app stores charge up to 30% for payments, paying processors a sliver, and highlighting the dynamics and power of scale in two-sided-market platforms.

While it's challenging, processors participating at multiple points across the value chain can create synergies, deliver more value, and, consequently, command better economics.

Industrial-strength consolidators FIS, Fiserv, Global Payments, Nexi, and Worldline are practiced at cutting costs. But they have failed to generate compelling revenue synergies across their issuer-processing, payment-network, and merchant-acquiring-and-processing assets—even while touting their ability to do so. And while these processing colossi enjoy advantages in scale, breadth of services, and delivery footprints, they often suffer management and innovation diseconomies of complexity and scale.

Entry barriers and the risks of building payment networks and the concomitant rewards are enormous. PayPal is a powerful two-sided payment network with critical mass online in many markets, serving consumers and businesses. Processor Block, too, has a leading P2P network and an interesting nascent, semi-open, retail-payment network in Cash App Pay.

Merchant processors Adyen and Stripe crossed the Rubicon to support issuance and issuer processing, rightly thinking serving large enterprises' acceptance, payout, and issuing needs provides greater value.

Payment processing for large enterprises is an oligopoly of scale play, and, while profitable, it's thin gruel. Entry barriers in serving smaller merchants, FIs, and fintechs can be relatively modest. While there are more competitors, asymmetries between sellers and buyers enable richer fees.

A Fly-Wheel Effect

With better mousetraps addressing particular niches, proprietary and sticky origination channels, and/or a bundling of additional services around payments, payment processing can be quite lucrative.

Dispersed client share benefits processors and networks alike enormously. In the overall market plunge, outliers Fiserv, Mastercard, and Visa are only down 5.2%, 7.1%, and 7.9%, respectively, from their highs.

At first blush, Fiserv's immunity to investor skittishness is a head-scratcher. Its portfolio of payments assets is similar to other consolidators

whose valuations have been devastated. But, net, Fiserv has delivered solid revenue and earnings growth. It's met expectations.

And its branded Clover platform is enjoying double-digit growth and flywheel effects from more merchants attracting more software and service providers that in turn attract more merchants. While it owns debit and bill-pay networks, Fiserv is best understood as a processing behemoth.

Mastercard's and Visa's resilient valuations are easier to fathom. They're the only two genuinely global retail-payment networks, and they enjoy ever-increasing network effects. For many would-be disruptors, plugging into and leveraging the global payment networks is the best path to maximizing value.

Fiserv's, Mastercard's, and Visa's revenue-valuation multiples of 3.9, 15.1, and 15.6, respectively, testify the market still understands and values Fiserv as a processor and Mastercard and Visa as networks. Payment networks at scale have pricing power. Processors at scale are often interchangeable.

Indispensable

Concerns over BNPL systems, digital currencies, and instant interbank-payment systems, while real, aren’t new and in most markets they’re hardly existential threats to the reigning payments ecosystem.

Most BNPL networks generate transactions for incumbent payment networks and processors. Meanwhile, cryptocurrencies aren’t fit for purpose. Stablecoins and central bank digital currencies have yet to find compelling use cases and a path to network critical mass. And, even where real-time payment systems serve retailers, as is the case with the Brazilian Pix system, they rely on traditional payment processors.

Notwithstanding battered valuations, payment processors are still an indispensable part of the payments ecosystem. Capital will be continually reallocated to its best uses. Payment processors and networks demonstrating robust, sustainable, profitable growth will be rewarded by the market.

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