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White Paper

Merchant Acquiring: How to Win in a Digital World

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In 1897, the American writer Mark Twain told a newspaper, "The report of my death was an exaggeration." The merchant acquiring industry could make the same claim. Just ten years ago, there were dire predictions of commoditization, of relegation to being a "dumb pipe," and of a race to the bottom in pricing to achieve scale. Today, the merchant acquiring space is experiencing a renaissance highlighted by an unprecedented rate of industry consolidation and digital transformation. The renaissance is being fueled by the rise of digital commerce and technological advancements that are spawning inexpensive hardware and software-as-a-service (SaaS), enabling easy integration. This digital disruption is allowing both incumbents and new entrants to offer new value propositions. It is redefining the power of scale and generating both new business models and an extended value chain. Not all stakeholders, however, will be able to reap the rewards of this renaissance. Many players are running sub-optimal merchant acquiring businesses and must decide whether to keep these businesses or spin them off. If they choose to stay in the business, as industry dynamics shift they will need to develop a strategy that generates sufficient returns.

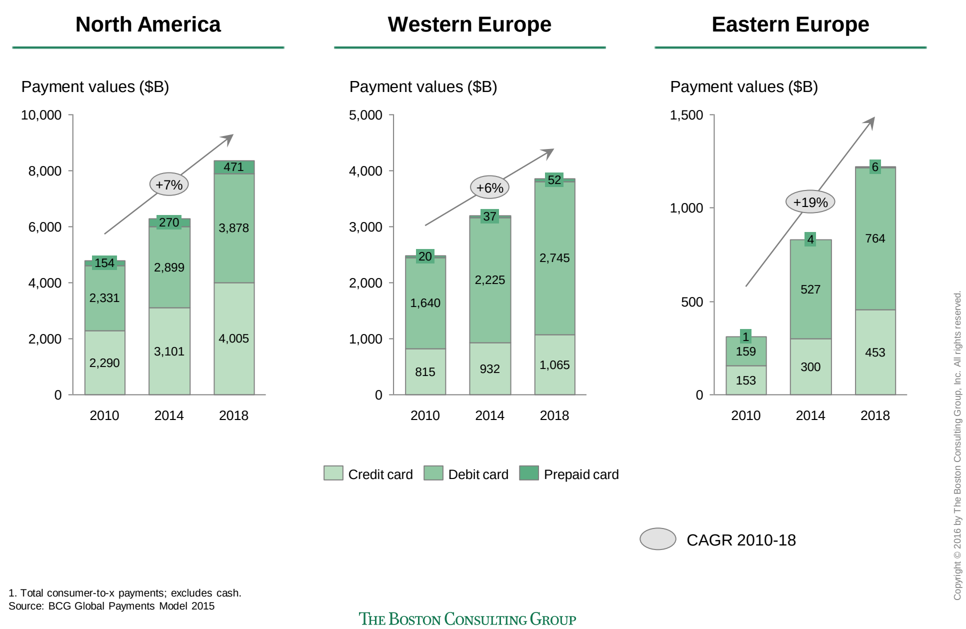
This article shares The Boston Consulting Group's (BCG) perspectives on the merchant acquiring business, including views on the performance of key players and the factors driving the renaissance. We will discuss how to excel in the digital world of merchant acquiring by focusing on three key success factors: first, delivering differentiated value-added services (VAS) and prioritizing the right VAS at the segment level; second, achieving distribution scale in integrated point-of-sale at the industry level; and third—to fulfill the above—executing an effective acquisition and partnering strategy.

Acquiring Is a Hot Business

Merchant acquiring is a business whose structural advantages and digital opportunities are generating strong valuations and exceptional total shareholder returns (TSRs), and, at the same time, spurring significant mergers, acquisitions, and initial public offerings (IPOs).

The merchant acquiring business has three structural advantages. First, it is a relatively low-risk business. While card transaction volume is cyclical, an economic downturn has far less impact on acquiring than on lending. Second, the secular shift from cash and checks to cards is driving steady volume growth even in mature markets. (See Exhibit 1). Third, the emergence of new mobile wallets (such as Android Pay, Apple Pay, and Samsung Pay) has solidified the role of card rails for the foreseeable future. In addition, merchants' desire to be EMV-compliant (Europay, MasterCard, and Visa) and/or cater to consumers who want to use NFC-based (near field communication) wallets, will accelerate point-of-sale (POS) system and terminal upgrades and could, thereby, fuel stronger adoption of integrated POS systems and VAS as discussed below.

Exhibit 1: Steady card purchase value growth in North America and Europe

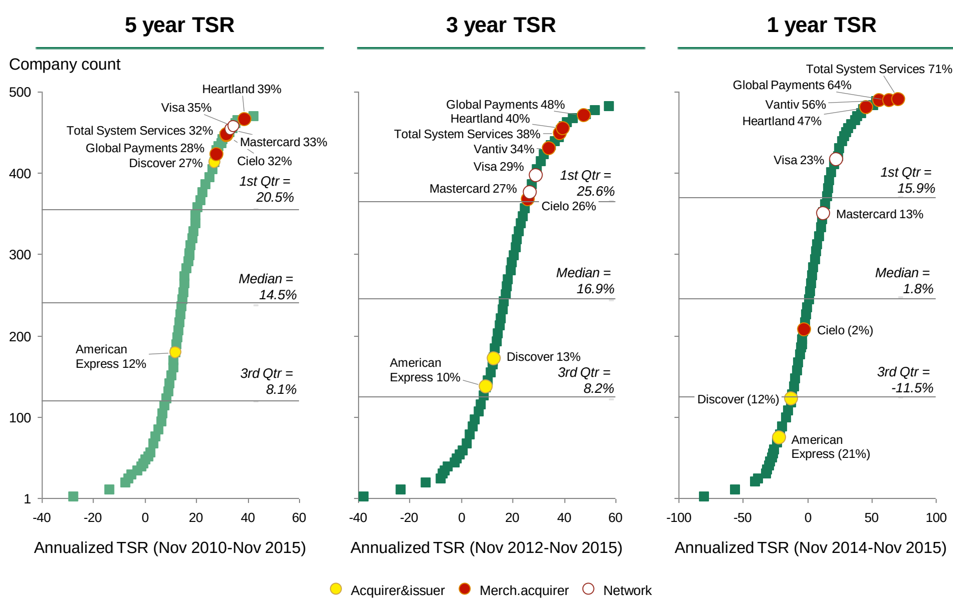


The positive effect of card growth on returns is being partly offset, but not erased, by margin compression. In North America, there has been erosion of 2 to 3 percent on average, per year. Margins in the large, national merchant segment have been eroding at a relatively greater rate than margins for micro and small merchants. In Europe, the regulatory cap on interchange is creating a windfall, pushing up acquiring margins, at least in the SME (small-to-medium enterprise, or firms with fewer than 1,000 employees) and micro merchant segments. The positive effect could be temporary, but is material is the short term. There is political pressure on banks to reduce total merchant service fees in order to fuel card acceptance by small businesses (part of a policy to "kill the cash" and thereby reduce tax fraud and money laundering).

Nonetheless, the acquiring business still generates relatively high multiples and above-average TSRs. For example, the majority of public merchant acquirers in the U.S. generate an enterprise value (EV) to EBITDA (earnings before interest, taxes, depreciation, and amortization) ranging from 13 to 16 and a price to earnings ratio (P/E) of 23 to 26 compared with the S&P average of 11 and 22, respectively (Q4 2015; Capital IQ). PayPal is off to a strong start with an EV/EBITDA of 20 and a P/E of nearly 37.

Merchant acquirers have also generated exceptional TSRs compared with the S&P 500. (See Exhibit 2 which shows annualized TSRs from November 2010 to November 2015.) Growth in P/E is the primary driver of their relatively high TSRs and valuations. Strong valuations indicate heightened market expectations regarding future performance, which, in turn, puts pressure on acquirers to fulfill these expectations. There will likely be winners and losers.

Exhibit 2: Payment companies outperform S&P based on TSR



Note: Background curve: S&P 500, based on data ending in November. TSRs use company reporting currency
Source: S&P Capital IQ; BCG ValueScience® Center

IPOs with strong valuations as well as numerous acquisitions and partnerships are evidence of the opportunity in merchant acquiring. November 2015 saw three IPOs (Square, WorldPay, and First Data) which followed PayPal's IPO in July. The market value of Square, which is the paragon of digital disrupters, is about 1.6 times greater than Heartland's, which ranked ninth in 2014 (ranked by card purchase value by the Nilson Report). The mergers and acquisition docket has been crowded (including Atos Worldline buying Equens; Advent and Bain acquiring Nets, and along with Clessidra, buying ICBPI in Italy), and will continue to be busy (Global Payments is buying Heartland Payments; TSYS is acquiring TransFirst; and Atos Worldline is rumored to be considering an acquisition of EVO Payments International). At the same time, many banks in Europe are increasingly partnering with leading acquirers that bring differentiated capabilities to the table (for example, PKO in Poland with EVO, and Erste Bank, CaixaBank, and Global Payments forming a joint venture to serve central and Eastern European retailers).

The Renaissance in Merchant Acquiring

The renaissance in merchant acquiring is concentrated in the SME segment and is being driven by two broad factors: the rise of digital commerce and technological advancements that spawn inexpensive hardware (such as tablets) and SaaS. These drivers, in turn, are enabling relatively easy integration and the ability to easily deliver new VAS.

Digital commerce driving growth and new revenue streams

The steady growth of e-commerce and the surge in m-commerce are enabling acquirers that excel in serving e-tailers to achieve above-average growth rates, earn relatively higher margins, and gain market share as well as new revenue opportunities. BCG expects digital commerce (including "in-browser" and "in-app") to account for about 12 percent of total retail commerce in the U.S. by 2018, up from 10 percent in 2015 (based on a moderate growth scenario). For Europe, BCG expects digital commerce to grow from 9 percent (2014) to 14 percent of retail sales by 2019--with Germany, the U.K., and France representing about two-thirds of total online retail sales by 2019.

Digital commerce growth is driving merchant demand for integrated services across channels (commonly called omnichannel services) and beyond. For example, retailers would like to have select promotions evenly pushed across their website, app, and stores. They would like to enable social media sharing and provide real-time purchase history across channels. This demand is causing new revenue growth opportunities to arise for merchant acquirers that can deliver an omnichannel experience to retailers' customers as well as provide consolidated purchase data across channels (along with advanced analytics).

New hardware, SaaS, and apps as building blocks

Inexpensive tablets and POS "stations" form the foundation of powerful next-generation POS systems available to SMEs. These new types of hardware combined with SaaS are driving significant advances in integrated POS (IPOS) systems (IPOS systems combine a cash register system, POS terminal, and value-added software). SMEs can now afford to replace their often outdated POS system, cash register, and larger terminals with streamlined hardware and relatively small terminals. SaaS has enabled SMEs to readily utilize an increasing variety of sophisticated software applications and has facilitated partnerships among merchant acquirers, hardware, and software providers.

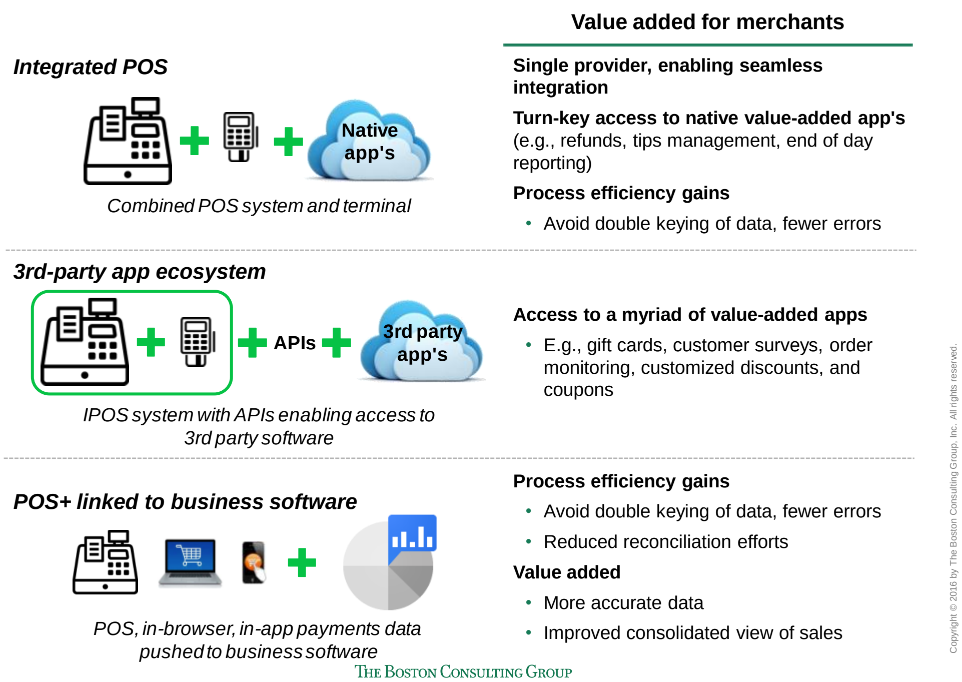
Smart phones used with applications that function as both POS and terminal could replace traditional systems. For example, Atos Worldline has launched a solution called HPE (also known as "host point of sale") that enables consumers to use the retailer's app to scan products and then pay via NFC by placing their phone near the merchant's phone.

Affordable hardware and software as well as turnkey merchant acquiring services are enabling micro and small merchants to easily accept cards. BCG estimates that the transaction revenue opportunity for merchants with under $100,000 in carded sales is nearly $2.5 billion, or about 15 percent of total merchant acquiring transaction revenues.

The result: easy integration and new value-added services yielding a new SME business model

The technological advances outlined above are driving three advanced integration models: IPOS systems, IPOS systems coupled with a third-party application developer ecosystem, and POS systems linked to business software (accounting, Enterprise Resource Planning or ERP, supply chain, etc.). (See Exhibit 3). Integration capabilities are not only generating new revenue streams for merchant services providers, but also providing an opportunity to increase retention and gain market share. The revenue opportunity of integrated services can be seen in the nearly $3 billion spent by Global Payments and Vantiv to acquire independent software vendors (ISVs) over the past two years. Moreover, forecasts for SME spending on SaaS overall are bullish. IDC estimates that SMEs spent about $12.5 billion on SaaS in 2015 and will spend nearly $17 billion by 2018. If merchant acquirers are able to capture just 10 percent of this market, they would add nearly 10 percent to their top line.

Exhibit 3: Seamless integration driving new services and revenue streams



IPOS systems can generate a win-win situation for merchants and merchant acquirers. The attractiveness of IPOS systems for SMEs lies in the process efficiency gains stemming from reduced manual labor (no data rekeying, etc.) leading to fewer errors and more accurate data. For SMEs, which typically have limited accounting resources, these efficiency gains have a significant positive impact.

For merchant acquirers, selling IPOS systems to SMEs is a powerful business model combining an attractive business segment with an attractive value-added service. In most markets, the SME segment is not only the dominant revenue generator (accounting typically for about 65 percent of revenues and less than 30 percent of purchase value) but has also experienced less margin compression than the large merchant segment. The benefits of offering IPOS to SMEs are many: margin preservation, a more compelling sales pitch (for instance, processing efficiency benefits), and access to SKU (stock keeping unit) data. Our experience suggests that margin decline for a merchant using IPOS is, on average, three percentage points less than the margin decline for a merchant not using IPOS. In addition, IPOS systems provide access to valuable SKU-level purchase data, and thereby have the ability to offer sophisticated purchase-behavior analytics as well as customer engagement and marketing services.

The pace of IPOS development and adoption varies across markets. The U.S. has been leading with digital disrupters such as Square, and incumbents such as First Data, Global Payments, and Vantiv, driving both development and adoption. A BCG survey of U.S. merchants found that 52 percent use IPOS and that 49 percent believe that IPOS capabilities will factor into their next buying decision. In Europe, the IPOS market is less mature. In a 2015 survey of U.K. SMEs, BCG found that IPOS system penetration was around 35 percent and that 50 percent of the merchants using an IPOS system had implemented it in the past 12 months.

When an IPOS system is combined with application programming interfaces (APIs) to support a third-party ecosystem of application developers, it opens the door to a vast array of applications which, for example, enable online pre-order and offline pick-up, appointments and reservations, and invoicing. Such applications can also offer loyalty and customer engagement services and analytics, inventory management, and payroll. In addition, there are emerging examples of POS credit offerings for consumers (such as Desjardins' Accord D). The result is the kind of turbo-charged VAS offering we see in First Data's Clover. Clover is succeeding at creating an attractive ecosystem of third-party developers and has about 350 applications available. At the same time, First Data is earning a new source of revenue from its revenue-share model with the application developers.

Integration of POS, in-browser and in-app payment systems, and business software has been spearheaded by firms such as Intuit and Sage, both of which own merchant acquiring businesses. This type of integration has multiple benefits for both the merchant and the payments provider. For SMEs, integration of the general ledger and payments systems increases efficiency significantly by reducing both manual reconciliation time and the costly and time-consuming manual errors themselves. For merchant acquirers, this type of integration dramatically reduces customer attrition and will likely increase customer satisfaction.

Winning in the New World of Digital Acquiring

As digital drivers and steady consolidation transform merchant acquiring, players that want to excel must achieve three key success factors:

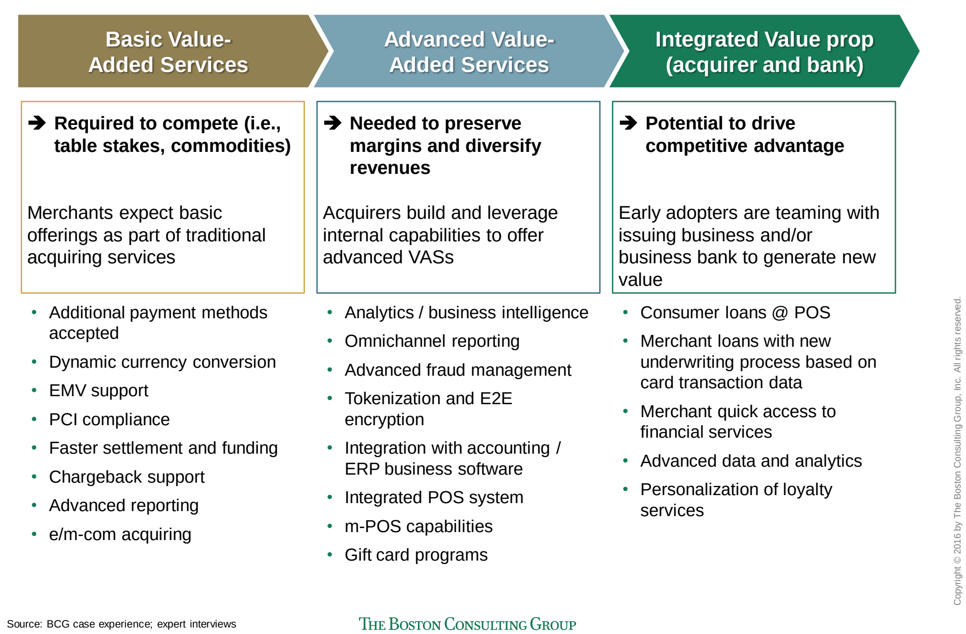
- **Deliver differentiated value-added services.** The ability to offer differentiated VAS is paramount to minimizing the impact of margin compression, increasing retention, and generating additional revenues. Moreover, acquirers need to be able to prioritize the right VAS at the segment level.

- **Achieve distribution scale at the industry vertical level.** Distribution scale is required to realize the potential of an integration-driven strategy. To excel in delivering IPOS systems—one of the most attractive VAS—an industry-specific approach is critical.

- **Execute an effective acquisition and partnering strategy.** To achieve the above key success factors, an acquisition strategy is probably necessary. For players with limited ability to acquire, an effective partnership strategy is critical.

Delivering differentiated VAS. Most acquirers have been trying to offset margin compression with revenues from VAS—from the basics such as PCI (payment card industry) compliance, fraud prevention, and analytics, to the more advanced tokenization, IPOS, omnichannel reporting, and integrated acquirer-issuer value propositions (See Exhibit 4). Results from VAS initiatives have been hit or miss and typically do not yet represent a large revenue stream (often less than 5 to 10 percent when excluding fees like PCI compliance). VAS, however, do not have to produce significant revenue stream to generate a return. VAS can mitigate the impact not only of margin compression but also of attrition. First, VAS-oriented sales pitches are driving a healthy move away from price as the focal point. Second, services such as tokenization and IPOS—which involve some integration—can increase switching cost and thereby reduce merchant attrition.

Exhibit 4: Evolution of VAS towards an integrated value proposition



Technological advances are enabling the development of differentiated VAS. Many leading merchant acquirers around the world are launching VAS that not only span the value chain but also extend to, for example, customer loyalty programs co-developed by the issuer and acquirer businesses, and new merchant lending models (see the vignettes below for profiles of the Commonwealth Bank of Australia and Square). These new VAS could prove to be strong new sources of revenue.

Vignettes of Best Practice VAS

Commonwealth Bank of Australia (CBA) Is Innovating Across the Board. CBA stands out for capturing digital opportunities that provide differentiated value to its merchants. It has developed its own proprietary tablet-based POS system called "Albert," and is building an acquirer-issuer ecosystem. Albert offers a variety of native applications that link merchants to other transaction accounts and banking products such as working-capital management, cash-flow management, and treasury services. CBA also provides merchants with reports based on customer-transaction data, including analyses of customers by gender, age, loyalty, and location—as well as local performance benchmarks based on competitor data. In addition, CBA has developed APIs for third-party developers to provide applications to its merchants, resulting in a vibrant third-party ecosystem.

Square Capital: A New Lending Model. A few merchant services providers have recognized that they can leverage their merchant-transaction data to deliver an overall improved working capital loan product—one that delivers a fast decision and, typically, next-day funding at a far lower rate than traditional merchant cash advance providers. Such products can include an easy payback process (for example, a fixed percent of each day's receipts handled by the merchant services provider is withdrawn to pay down the loan). While there are several players in the vanguard (PayPal, Amazon), Square Capital stands out for pre-qualifying its merchants and proactively reaching out to qualified merchants with several loan levels and payback options accessible by simply clicking a button on the merchant's Square dashboard. Square has been able to successfully scale this business by having third parties buy the vast majority of its receivables and by having an exceptionally high repeat-customer rate (90% of merchants that have been offered a second Square Capital advance have taken it). Square earns two direct revenue streams and one indirect: it charges the third parties buying its receivables an upfront fee and an ongoing servicing fee (similar to a mortgage servicing provider). It earns more payments processing revenues by enabling its merchants to grow faster than they might have if they had not been able to get such easy, low-cost funding.

Achieving distribution scale at the industry-vertical level. A new competitive advantage has arisen at the confluence of distribution scale and VAS. The power of scale has extended beyond low-cost processing and operating leverage to distribution. A decade ago, the focus was on building back-end scale. Today, the growing importance of indirect sales and referral channels, along with the rise of VAS and the need to integrate with specific software solutions, is making front-end scale paramount. Top merchant acquirers are finding that their distribution scale and ability to accelerate the go-to-market process give them significant clout with independent software vendors (ISVs). ISVs are willing to earn less revenue share from top acquirers and/or in some cases, sign exclusive distribution deals. By contrast, acquirers handling under $100 billion in carded value are finding it hard to get the attention of the leading ISVs. In addition to overall distribution scale, vertical-specific distribution scale will be critical to driving down merchant acquisition costs and maintaining profitability.

To excel in selling IPOS systems and VAS, leading merchant acquirers and ISVs have realized that offering industry-specific solutions is paramount—solutions that have the flexibility to customize the user interface and the ability to be integrated into their business systems. For example, an ISV serving the health care industry will choose to partner with an acquirer which is strong in that industry. There are numerous examples of industry-specific needs. Retailers would like an IPOS system that can be easily integrated into its inventory management system (or provide them with such a system). Convenience stores would like real-time analytics that tell them what inventory is not moving so they can reconfigure their product placements. Quick-service restaurants require an IPOS system that enables them to get orders to the kitchen quickly and turn tables over fast. Doctors and dentists want a POS solution that is easily integrated with their patient-management systems. When a merchant acquirer can offer industry-specific solutions, it can drive a technology-focused sales discussion and diminish the focus on price.

Executing an effective acquisition and partnering strategy. In order to achieve the above key success factors, most top acquirers will need to pursue an acquisition strategy. The reason is that it is too late to grow organically until the next disruption occurs—for example, when and if real-time payments become ubiquitous). Those not in the top tier need to determine if they want to remain in the business…or sell, as Heartland Payments and TransFirst recently did in the U.S. In Europe, mid-sized banks still running an acquiring business will have to think hard about whether they can realistically build the technology and commercial know-how required to remain competitive. Depending on their market share and product scope, merchant acquirers have three acquisition plays that they can potentially pursue: gain distribution scale, extend and differentiate their capabilities in their core business, and expand into adjacent merchant services. Partnering is another option that can build distribution scale and extend capabilities, as well as provide experience in new markets and/or products.

Most top acquirers can benefit by increasing their distribution power. In the U.S., a prime example of this is Global Payments' upcoming acquisition of Heartland Payment Systems, which will extend its presence in the SME market. Global Payments was willing to pay a premium to build market share in this highly attractive segment and cross-sell its IPOS system. In the U.K., First Data has leveraged Clover to build market share.

To gain differentiated capabilities, many acquirers are pursuing M&A strategies. This strategy is seen in WorldPay's acquisition of SecureNet (an ISV with omnichannel services), First Data's acquisition of Clover (IPOS system), and Vantiv's purchase of Litle & Co. (e-commerce). Another revenue growth driver is expansion into adjacent merchant services. Merchant acquirers can expand beyond payment-card-related services for a specific industry. For example, Heartland, through its acquisition of ECSI, expanded its services to higher-education institutions to include student tuition, loan, and tax services. Through its acquisition of Payroll 1, it added payroll services.

Partnerships are a relatively low-cost and low-risk approach to building distribution scale and product scope. This route can be highly attractive for banks with a sub-optimal merchant acquiring business that want to remain a full-service financial-services provider and which view merchant acquiring as a means of building relationships, improving retention, and selling new services (such as credit cards). Recent BCG research shows that banks' acquiring offerings are starting to fall behind those of the leading, standalone merchant acquirers. A way of staying ahead is to partner with a merchant acquirer that is investing in technology and integration, in other words, one that has a strong IPOS offering. Conversely, large merchant acquirers/processors can partner with banks to provide low-cost processing services or to tap a relatively low-cost distribution channel. In addition, large merchant acquirers find partnering with innovative hardware/software providers an easy starting point for gaining experience with a new product (Vantiv has partnered with Poynt, a smart POS terminal provider. Elavon has partnered with talech to offer a cloud-based POS system).

In conclusion, the world of acquiring will look very different in 2020. The industry titans will have continued to gain market share. Integrated, industry-specific VAS will be more prevalent. Early VAS movers will likely maintain their lead. In addition, there will be a shift to automated and indirect sales channels. The number of sub-scale merchant acquirers will fall precipitously, in particular in large, homogeneous markets such as the U.S. Therefore, organizations with a merchant-acquiring business should evaluate their ability and desire to fulfill the key success factors outlined above, and decide if they should either spin off or boost investment in their businesses.

As Mark Twain also said, "The secret of getting ahead is getting started."

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