

Global Equity Observer

Paying up

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | JULY 2020

The payments industry is gradually emerging as one of the most attractive parts of the financial technology (Fintech) world. Prior to COVID-19, approximately 50% of transactions globally were done in cash.¹ COVID-19 has forced many in-person transactions online, where cash is not a practical way to pay. Furthermore it is likely physical money is a vector for the transfer of the virus.

Once consumers are habituated to using more convenient digital payments, the shift away from cash should remain structurally higher in the post-COVID-19 world; digital payment volume growth is expected to be in excess of 12% per annum in the medium term, an attractive tailwind for the sector.²

The payments universe is complicated and there are a range of players with differing roles and value propositions. Broadly speaking there are three main categories—Card Issuers, Card Networks and Merchant Acquirers. Card Issuers are mostly banks and credit card companies who issue credit and debit cards to retail or wholesale customers. Card Networks provide the infrastructure and the rulebook for the exchange of authorisations and funds. Merchant Acquirers provide the connection between the shops or websites that accept the payment and the Card Networks.

¹ Source: Capgemini World Payments Report 2019

² Source: Capgemini World Payments Report 2019

AUTHORS



**DIRK
HOFFMANN-BECKING**

Executive Director
22 years of
industry experience



ALEX GABRIELE

Executive Director
11 years of
industry experience

“With consumers now in the habit of using digital payments, the shift away from cash should remain structurally higher in the post-COVID-19 world”

For instance if customers swipe their cards to pay for their fully loaded COVID-19 shopping trolleys at the local supermarket, the device sends a message to the Merchant Acquirer asking for authorisation of the payment. The Merchant Acquirer sends the message through the Card Network, which forwards it to the Card Issuer. If the Card Issuer confirms the card to be good for payment, the authorisation is conveyed back through the Card Network to the Merchant Acquirer and finally to the supermarket. Depending on the card used and geography, for every \$100 shopping basket the consumer buys, the supermarket receives approximately \$98.00 to \$99.00 whilst the Merchant Acquirer gets a \$0.10 to \$0.20 fee, the Card Network collects a fee of around \$0.20 and the Card Issuer gets generally \$0.60 to \$1.30.³ Optically it looks like Card Issuers are making the most money, but in reality they pass some of the fee back to consumers in the form of incentives like air miles, cash-back or reduced foreign exchange fees.

“Traditionally the pure card networks have been the most attractive part of the payments ecosystem”

Card Networks – the resilient part of the system

Traditionally the two pure card networks, Visa and MasterCard, have been the most attractive bottleneck in the ecosystem. They have a strong set of three overlapping moats—a network of consumers, a network of merchants and a network of financial institutions. These overlapping moats have proven very difficult to break. There are some vertically integrated operators, domestic card networks and new emerging electronic payment providers, but without the help of government regulation tilting the playing field, and extensive capital, it has proven very hard to compete; the majority of these alternatives lack the scale of investment, international reach or service quality to compete with Visa or MasterCard. That has allowed Visa and MasterCard to maintain stable and often dominant market shares in a growing market, with the persistent global move from cash to card.

Merchant Acquirers – making progress

Most merchant acquiring activity is still done by banks, particularly in Europe. Historically it was a part of commercial banking services that banks provided to their clients. Over time the inherent economies of scale in this business have resulted in the emergence of initially bank-owned utilities and now independent commercial operators that provide processing and merchant acquiring services. These companies pursue one of two strategies. Either they consolidate the existing merchant banking infrastructure under one roof and create synergies from streamlining systems and cost, or they operate one unified

technology stack and acquire customers organically. Players like Adyen, Stripe and PayPal have pursued the second strategy and saw very strong growth at highly attractive economics resulting in elevated valuations. At the same time some of the consolidators that trade at more digestible multiples are making good progress based on sensible pricing of deals and improving integration skills.

Card Issuers – buried in the banks and credit companies

Most issuing activity sits within banks and credit card companies. They sometimes outsource the processing part to gain economies of scale but tend to hold on to the core issuing activity, which gives access to the interchange fee. Whilst card issuing produces very attractive returns, with some variance depending on how much they have to give away in direct or indirect incentives, these activities are rarely big enough to drive the economics of the organisations where they occur.

Data – the next frontier

The current investment case rests on the benefit of consolidating what is by nature a largely fixed cost business. Beyond this, the payments industry provides an unrivalled treasure trove of data on which to build value-added services.

“Ultimate success will be determined by who can generate the highest quality data”

For example, fast food restaurants are putting up kiosks in their restaurants where you can order food to pick up at the counter. Customers tend to order more or higher value items at the kiosk, maybe because they feel less under pressure from the people waiting in the queue behind them. A similar trend is happening with the use of apps. Creating a tool that helps fast food restaurants project the return on investment for the kiosk, based on their existing customer base, could be of material value.

Ultimate success in this industry will be determined by who will be able to generate the highest quality data. Some of the large banks who have both issuing and acquiring under one roof should, in theory, be best equipped. However, this requires integration across often separate divisions (retail and commercial banking) and a material upgrade and integration of existing systems. Historically banks, in particular incumbent banks, have struggled with these kind of challenges. Card Networks have by far the deepest set of data. However, their role at the centre of card payments is not just one of processing, but also to be the arbiter and rule maker between acquirers and issuers. It will be difficult to remain a referee whilst competing with the contestants on data.

³ Source: Adyen, NEXI, Visa and Morgan Stanley Analysis

Some of the Merchant Acquirers are positioning themselves in value-added services. Similar to the banks, the system architecture will be critical to success, favouring the single technology stack players. Recently established digital wallets like ApplePay and GooglePay are also in a strong position assuming they can integrate the payments data with their other databases.

Implications

From an ESG perspective, the shift to digital payments away from cash may lead to the financial exclusion of people without access to the banking system, especially in emerging markets. Visa is acutely aware of this and has been helping unbanked individuals access electronic payments accounts, with the aim

of meeting 500 million people by 2020. The shift to digital also raises payment security issues. Visa has been investing heavily in data security. They received the highest rating in the sector from Gartner Consulting during their 2019 cybersecurity program review, and also prevented approximately \$25 billion in fraud using artificial intelligence

As quality investors with a focus on downside protection we have always been drawn to the Card Networks given the robustness of their business model and scale economics. Banks and pure credit card companies are out of bounds for our global portfolios due to low returns and high leverage. Merchant Acquiring is more interesting, although valuations are very elevated for players with single technology stacks.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. Stocks of small-capitalization companies carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Option writing strategy.** Writing call options involves the risk that the Portfolio may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the Portfolio forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price, but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the Portfolio's call option writing strategy may not fully protect it against declines in the value of the market. There are special risks associated with uncovered option writing which expose the Portfolio to potentially significant loss.

DISTRIBUTION

This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

Ireland: Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's, Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Regulated by the Central Bank of Ireland. **United Kingdom:** Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA. **Dubai:** Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158).

Germany: Morgan Stanley Investment Management Limited Niederlassung Deutschland, Grosse Gallusstrasse 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 08829360968. **The Netherlands:** Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 11096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of Morgan Stanley Investment Management Limited.

Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Switzerland:** Morgan Stanley & Co. International plc, London, Zurich Branch Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41(0) 44 588 1074.

U.S.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.

Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley funds.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

Hong Kong: This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This document should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"); (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This publication has not been reviewed by the Monetary Authority of Singapore. **Australia:** This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

Japan: For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied

by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

IMPORTANT INFORMATION

EMEA: This marketing communication has been issued by Morgan Stanley Investment Management Limited ("MSIM"). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's / product's relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing.

This material is a general communication, which is not impartial and has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Except as otherwise indicated herein, the views and opinions expressed herein are those of the portfolio management team, are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation.

Additionally, financial intermediaries are required to satisfy themselves that the information in this document is appropriate for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM's express written consent.

All information contained herein is proprietary and is protected under copyright law.

Explore our site at www.morganstanley.com/im