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.

“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”

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\(^1\) Source: Capgemini World Payments Report 2019
\(^2\) Source: Capgemini World Payments Report 2019
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. 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, cashback 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.

2 Source: Adyen, Nexi, Visa and Morgan Stanley Analaysis
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.

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