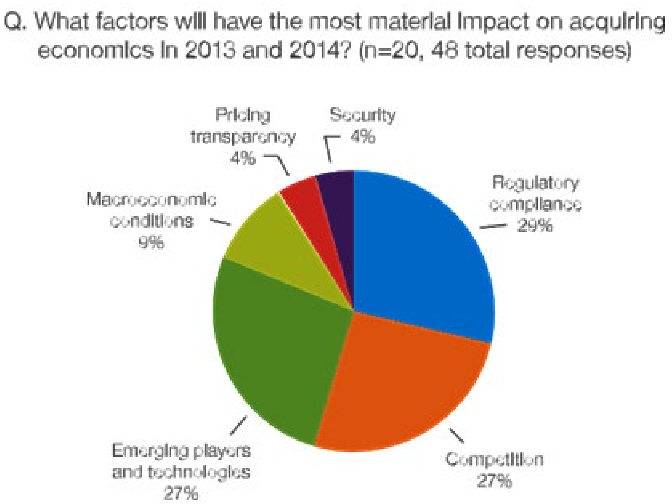
The Future Of Merchant Acquiring:
The Best Of Times And The Worst Of Times.

INDUSTRY INSIGHT

A Tale of Two Cities

The merchant acquiring market in the United States is the largest and, arguably, most advanced in the world. The market landscape involves a variety of players including large acquiring banks and third-party acquirers as well as bank and non-bank joint ventures.



A considerable amount of industry research has been published recently by firms such as Lafferty and The Aite Group. Throughout the blogosphere, additional information and commen- tary has been offered by both those inside and outside the industry concerning not only the current condition but also future trends of the segment.

The focus is understandable. Merchant acquiring is an attractive business that currently continues to return significant value to its stakeholders. However, possibly no other segment in the payments space is facing as many potential business challenges and disruptive alternative technologies. For merchant acquiring, it is the best of times and the worst of times.

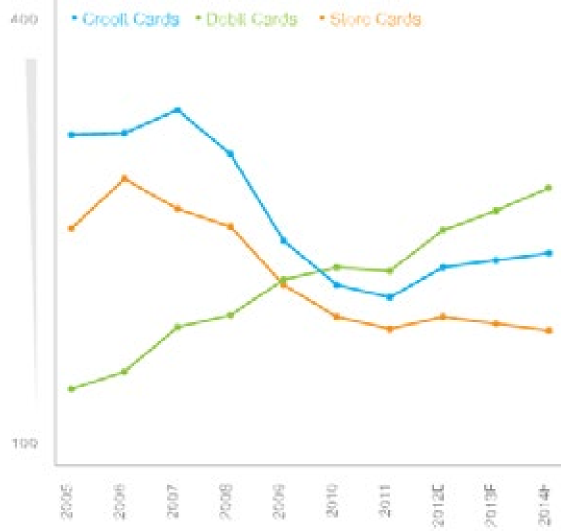
The Best of Times

The billed volume of credit and debit cards is one indicator of the sheer size and value of the merchant acquiring market in the U.S. According to Lafferty[1], the U.S. accounts for 39 percent of global POS credit card payments with steep growth trends projected across all transaction types with the exception of POS Debit.

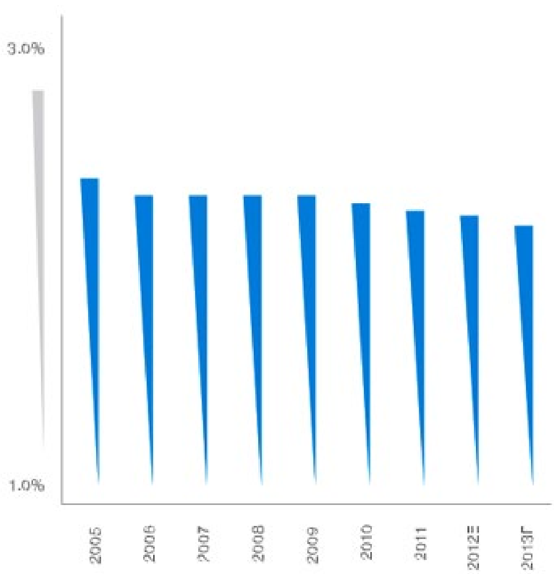
In 2012, POS credit cards billed volumes in the U.S. recovered to the 2008 pre-crisis peak. This represented the replacement of the more than $181 billion lost in the U.S. market when it contracted by 8.5 percent in 2009.

Lafferty's statistics on the number of cards in the wallets and purses of consumers is a clear indication of the depth and breadth of the US merchant-acquiring marketplace[2].

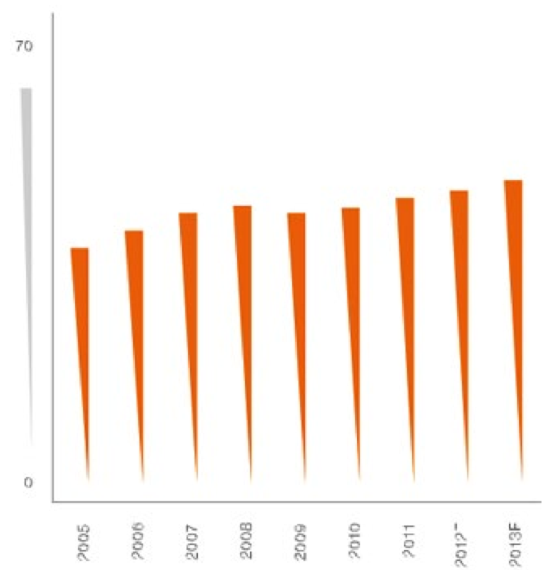
US: Average number of cards per 100 adults



Credit card merchant service charges (MSC)



Credit card Income from merchant service charges (MSC)



The trend lines related to the number and type of cards held by adults in the U.S. depicts a recovery since the economic downturn in 2008 and a steady growth of credit and debit cards. The decrease in the number of store cards held per 100 consumers is a result of more merchants turning toward co-branded, network sponsored cards and away from the overhead and expense of offering their own programs[3].

1 Merchant Acquiring: North America, The Lafferty Group, 2013
2,3 Ibid

The lucrative nature of the U.S. merchant acquiring market attracts a large number of competitors. Even though the top four U.S. acquirers account for more than half of payment card transactions in the country, the scale of the U.S. payment card market means there are large revenue opportunities available for even the smallest of merchant acquirers.

Independent service providers make up an important segment of the US merchant acquiring market providing a lower cost option for signing up merchants for acquirers and delivering front-end solutions to the merchants. By servicing riskier merchant accounts, where a higher likelihood of fraud exists, ISOs service a segment not addressed by traditional merchant acquirers and are able to charge higher fees.

Competitive factors that differentiate the organizations that make up the market include; brand, price, features, functionality, scalability and service levels. In the U.S., international third party acquirers play a significant role in differentiating the environment from most others around the world where a few local banks compete for business.

Merchant service charges (MSCs) represent the bulk of the revenue available in the merchant acquiring industry in the U.S. Across North America, MSCs have been on a steady decline in recent years.

However, when compared to other regions around the world, the MSCs in North America in general and in the U.S. specifically have been relatively consistent. The Lafferty Group reports that between 2005 and 2012, MSCs in Canada, the U.S. and Mexico, fell only eight percent, well below the global average decline of 21 percent[4].

Despite falling revenues from MSCs have increased consider- ably in recent years thanks to the level of billed volume growth. In 2009, MSCs in the U.S. fell nearly $4.3 billion. However, total U.S. income from MSC reached $49.2 billion in 2012, up $4 billion or 10.5 percent from the 2008 peak[5].

The Worst of Times

What could be wrong with this picture? Credit and debit card payments are once again moving upward. U.S. consumers have plenty of cards available to them for use at the point-of-sale. MSCs are on the decline but continue to provide revenue growth for merchant acquirers.

However, below the surface, merchant acquiring has reached a critical phase in its life cycle where organizations face extinction in one form or another unless they transform their business. This quote from Richard Oglesby of The Aite Group accurately describes the state of affairs:

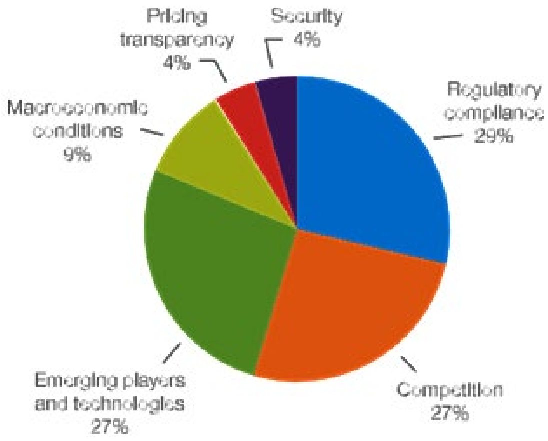
> "The merchant acquiring business, built around personal sales channels and payment-specific products and solutions, has reached a point of maturity, commoditization, and margin compression. If a payment terminal is analogous to a telephone, acquirers have increasing become the dial tone, comparable to a wired telephone company that lacks significant differentiation from competitors." [6]

4,5 Ibid
6 Transform, Consolidate or Die: U.S. Acquirers on an Unsustainable Path, The Aite Group, 2013

During a webinar entitled "Easing the pain, finding new growth - The need for a merchant acquiring technology refresh." available for viewing on Vimeo, Oglesby presented research done by The Aite Group with more than 20 merchant acquirers. It is evident from these results that organizations understand they are facing a sea of change due to several different dynamics that threaten to further commoditize their businesses.

These challenges are nearly equally spread across three areas; regulatory compliance, pressure from existing competitors and new competitors with emerging, disruptive technologies[7].

Q. What factors will have the most material impact on acquiring economics in 2013 and 2014? (n=20, 48 total responses)



Regulatory Compliance and Downdraft On MSCs

Regulatory pressures have always been a part of the merchant acquiring industry. However, of late, a series of class action lawsuits in the U.S. credit card industry are likely to add further pressures on credit card interchange fees.

Though these suits and associated settlements have impacted mainly issuers, they could have an effect on organizations throughout the payments ecosystem, including acquirers. It appears likely that maintaining its relatively high MSCs in the future will be difficult for the U.S. credit card acquirers.

MSCs in the U.S. market are nearly double in comparison to those in Western Europe, a similarly advanced market. Regulatory pressures on credit card MSCs in Western Europe may provide a glimpse into their future in the U.S. merchant acquiring market where these charges are increasingly under regulatory scrutiny.

The easing of surcharging rules allowing merchants to pass interchange charges onto consumers represents another potential for pushing MSCs lower. Many merchants are understandably cautious about implementing these surcharges since consumers are likely to act adversely. For acquirers, the threat is that such action may create a decline in the use of credit cards.

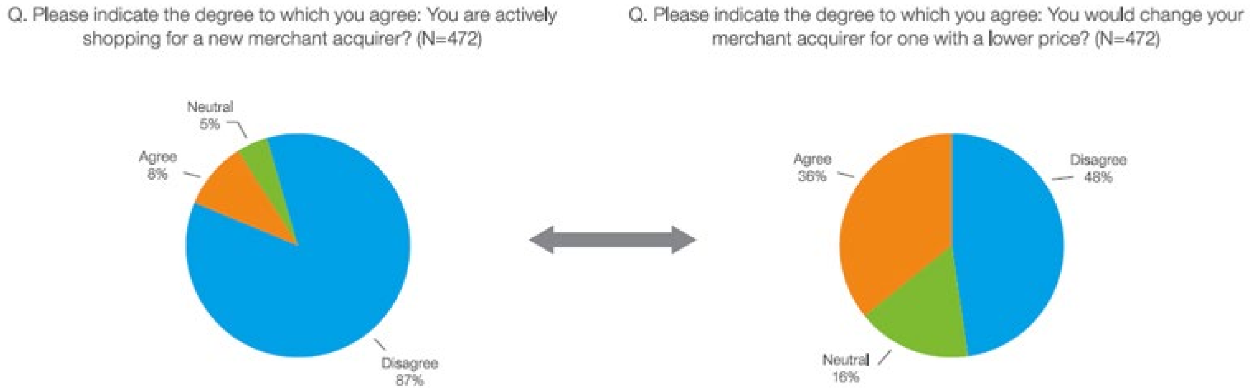
Though strong growth is forecast for MSCs over the next few years, most of the organizations that depend on these charges are concerned about the impact these ongoing lawsuits and regulatory oversight may create for their businesses. The threat of a significant loss of revenue is real. According to Lafferty[8], if MSCs in 2012 in North America had been equivalent to those in Western Europe, the region would have lost $23.9 billion dollars of income from MSCs.

7 Ibid
8 Merchant Acquiring: North America, The Lafferty Group, 2013

Industry Competition: The Race To The Bottom

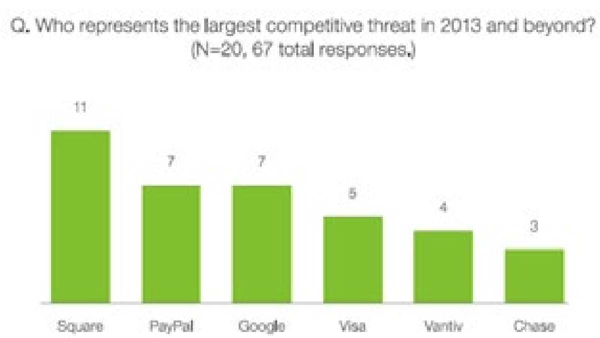
While expenses related to areas such as regulatory compliance drive up costs for merchant acquirers in the U.S., competition amongst industry players is driving down the revenue per transaction creating what Aite's Oglesby calls "the race to the bottom[9]."

The reality of this phenomenon is depicted in the charts below from the Aite webinar on Vimeo. While 87 percent of the retailers surveyed indicated they were not actively looking to replace their existing merchant acquirer, 52 percent indicated a willingness to explore changing their acquirer in the event another organization offered lower fees[10]. More than a third of those surveyed stated that they would change if they got an offer from another acquirer, which reduced the fees they paid. Smaller merchants, in particular, have a greater tendency to be price sensitive as the largest merchants have typically already negotiated very attractive fees from their acquirers.



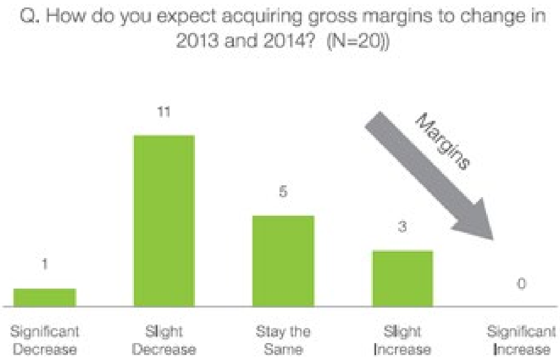
Having one-third of the merchant acquiring market in play, for any reason, creates the possibility for a significant level of account turnover. The fact that the driver for changing vendors, in this case is price, further amplifies the commoditization in the industry. As organizations compete for business based on price, they further limit their ability to offer their customers innovative products and services.

This "race to the bottom" weakens an industry already under considerable pressure from emerging technology providers leaving it with limited resources for fighting the battle at hand. Disruptive innovation from non-traditional players becomes the real threat to the traditional franchise of merchant acquirers. These non-traditional competitors, which include well funded start ups and cash rich mature companies, represent a material threat to traditional merchant acquiring companies as they seek to fuel their growth by carving out a share of the $4.4 trillion retail space.



Several organizations across a spectrum of business models are leveraging a variety of products and technology to create proprietary solutions that expand the value delivered to the merchant beyond simply providing a "dial tone." Some of these are

9 "Easing the pain, finding new growth - The need for a merchant acquiring technology refresh", ACI Worldwide and The Aite Group, 2013
10 Ibid



relatively new players, such as Square and Level Up. Others are established players – e.g., PayPal, Google, Amazon, Intuit – with significant amounts of cash to invest in capturing new market opportunities.

When asked by Aite to identify who they considered to be the largest competitive threat in 2013 and beyond, the majority of those surveyed named organizations not traditionally part of the merchant acquiring landscape[11].

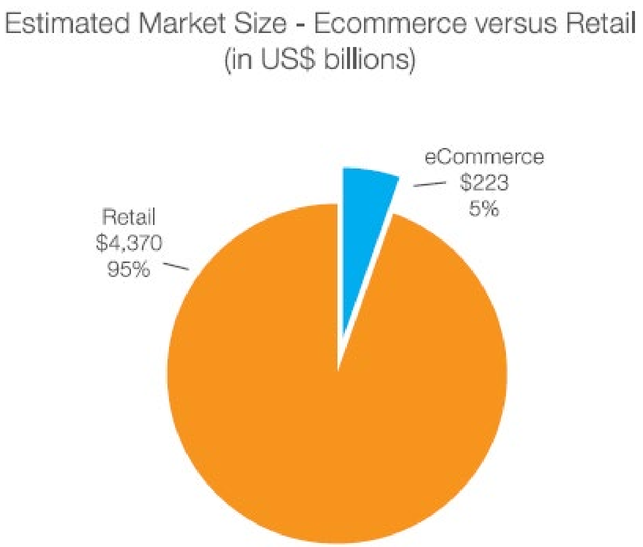
The focus on Square, and mention of traditional "partners" for merchant acquirers such as Visa, may be surprising to some as these players currently facilitate the flow of transactions through the existing payment rails. However, emerging players that facilitate access to additional market segments – e.g., very small retailers – have a history of becoming competitors (e.g., PayPal) while networks have the ability to reach the retailer directly with add value services and disrupt the value chain of the acquirers.

It is interesting to note that Amazon was not listed as a competitor by those participating in the survey. While Amazon is not a payments company, per se, they do process payments while offering a comprehensive set of value-add services that facilitate the merchant's path to market and decrease their need for large amounts of capital to address such area as order fulfillment and customer service.

However, if the POS terminal has become equivalent to a phone and the acquiring function simply the dial tone, why would the likes of Amazon, Google or eBay want to be involved in servicing merchant payment transactions?

11 Transform, Consolidate or Die: U.S. Acquirers on an Unsustainable Path, Aite Group, 2013

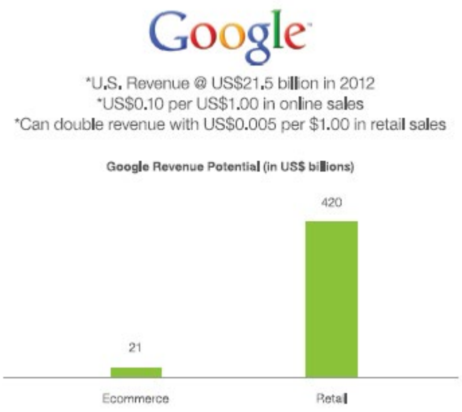
After all, these companies are very successful in servicing the $223 billion e-commerce segment. As impressive as that number is, it represents only five percent of the total addressable market available to them.

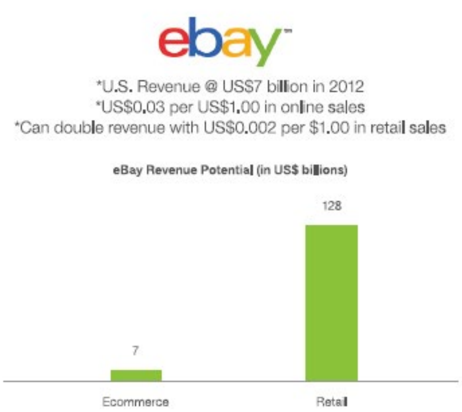


Clearly, Amazon, Google, PayPal, eBay and others are not after the merchant acquiring business alone. They are looking to become the value-added service provider to a portion of the 95 percent of the market they do not have large share in today. With a value of $4.4 trillion the traditional retail market is their real interest[12].

The impact of unlocking the potential of this larger market segment on the value of these companies is remarkable. For example, if Google were to capture half of one cent of each dollar of traditional retail sales the company would realize an additional $420 billion in revenue. For eBay, just one fifth of one cent of each dollar of retail sales adds another $128 billion dollars to the top line[13].

How Will The Story End?





Merchant acquirers find themselves in the middle of a perfect storm composed of rising costs for regulatory requirements, downward pressure on pricing created by competitive forces in their industry and disruptive technology being introduced by e-commerce players interested in capturing a share of the lucrative retail market.

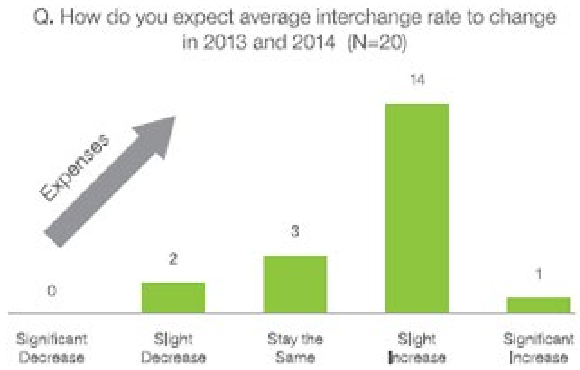
The impact of this perfect storm on the future was reflected in the Aite Group's study[14]. Respondents indicated their expectations were that in 2014 they expected merchant discount rates to go down while expenses continue to rise.

How the story ends will be determined by how merchant acquiring companies address these trends. Gaining operational efficiencies, increasing focus on growth areas and developing innovative, value-added services for merchants represent three strategies that merchant acquiring organizations can utilize to insure the story ends in a fashion that delivers the best value to their stakeholders.

Many acquiring organizations are built on a foundation of legacy systems and software. Efficiencies that lower operating costs

12 "Easing the pain, finding new growth - The need for a merchant acquiring technology refresh", ACI Worldwide and The Aite Group, 2013 Webinar.
13 Ibid
14 Transform, Consolidate or Die: U.S. Acquirers on an Unsustainable Path, Aite Group, 2013

can be gained through modification of the processes used to support and enhance these systems. For example, one of the world's largest card networks optimized their test environments across a multi-vendor, heterogeneous application landscape reducing effort and improving productivity by 50 percent over four years[15]. Streamlining and automating existing processing environments, e.g., around dispute management, helped this same organization reduce costs by streamlining compliance requirements and improving time to market[16].



In addition to decreasing costs to deal with compliance overhead and pricing strategies by traditional competitors, focus can be a way to drive revenue through specialization in a high growth sector. For example, servicing merchants in e-commerce space has helped companies such as Vantage Card Services outperform other similarly sized merchant acquiring companies. Vantage's customers process, on average, more than three times the average number of transactions in the industry. The growth is likely to continue as the expansion of e-commerce continues in the U.S. and around the world. The fact that Vantage delivers with its services to its target market with a robust set of value-added services helps create and maintain customer loyalty.

To address these threats, particularly from new and established disruptive players, traditional merchant acquiring companies will need to seek opportunities to deepen relationships with merchants by offering value-added services that help them drive incremental sales (e.g., analytics, loyalty, geo-based offerings). These value-added services will manifest in the form of new technologies that drive convenience and choice to the consumer in an environment that secures the payment types they use for their purchases.

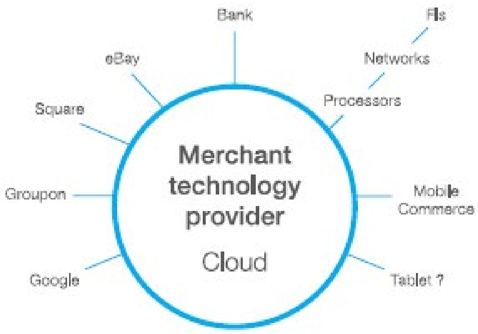
Using savings gained through efficiency and the growth of revenues from MSCs that is expected to continue for the near term, merchant acquiring companies have an opportunity to drive their own wave of innovation through the industry defending their turf from new entrants. To achieve, merchant acquirers will need to consider partnerships with companies that possess both the industry expertise and technical resources to create these waves of innovation.

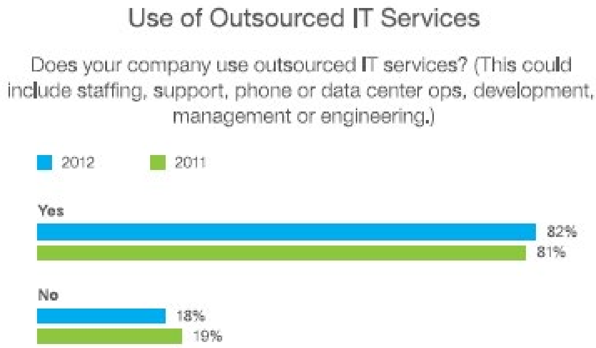
Heartland Payments Systems is an example of a merchant acquiring organization that has successfully created an environment where the creation of value-add products and services is the norm. Working across multiple retail segments, Heartland has established itself as one of the top technology innovators in the United States. Information Week has recognized Heartland's role in driving innovation

15 High Value Testing Solution For World's Largest Payments Networks, ©2012
16 Payments Expertise Improves Compliance & Reduces Time to Market, ©2013

in the industries it serves by most recently naming Heartland in the top 20 percent of U.S. companies. Other companies have the opportunity to follow Heartland's lead and innovate from within the industry to prevent disruptive forces from reconfiguring the landscape.

Pursuing one or more of the strategies noted will present many merchant acquiring organizations with a considerable challenge. Often the majority of resources within their operations are focused on maintaining the existing systems in place. The ability to step back from day-to-day concerns and assess areas of savings, focus and innovation is difficult. In addition, the level of subject matter expertise and technical skill sets required, especially on the emerging technology front is lacking. Building out the team and attributes required internally will require a considerable amount of time to screen, select, hire and integrate employees raising issues around time to market.





These same concerns are why many organizations are choosing to seek outsourcing partners to assist them on a project basis. In a study entitled "The State of Outsourcing in 2012," Information Week reported that over 80 percent of the respondents use outsourcing services.

Corporations in the United States have engaged in leveraging outsourcing for the past four decades. In the area of technology outsourcing, it has become a $100 billion industry in just a short span of last 20 years. According to McKinsey research, outsourcing has accelerated time to market while bringing cost structure efficiencies for technology infrastructure. This trend is expected to continue for many years to come.

The Information Week study also indicated that in 2011 and 2012 the top three benefits organizations most often sought to obtain through outsourcing addressed the need for more staff, skills and expertise that many merchant acquirers have in their organizations[17].

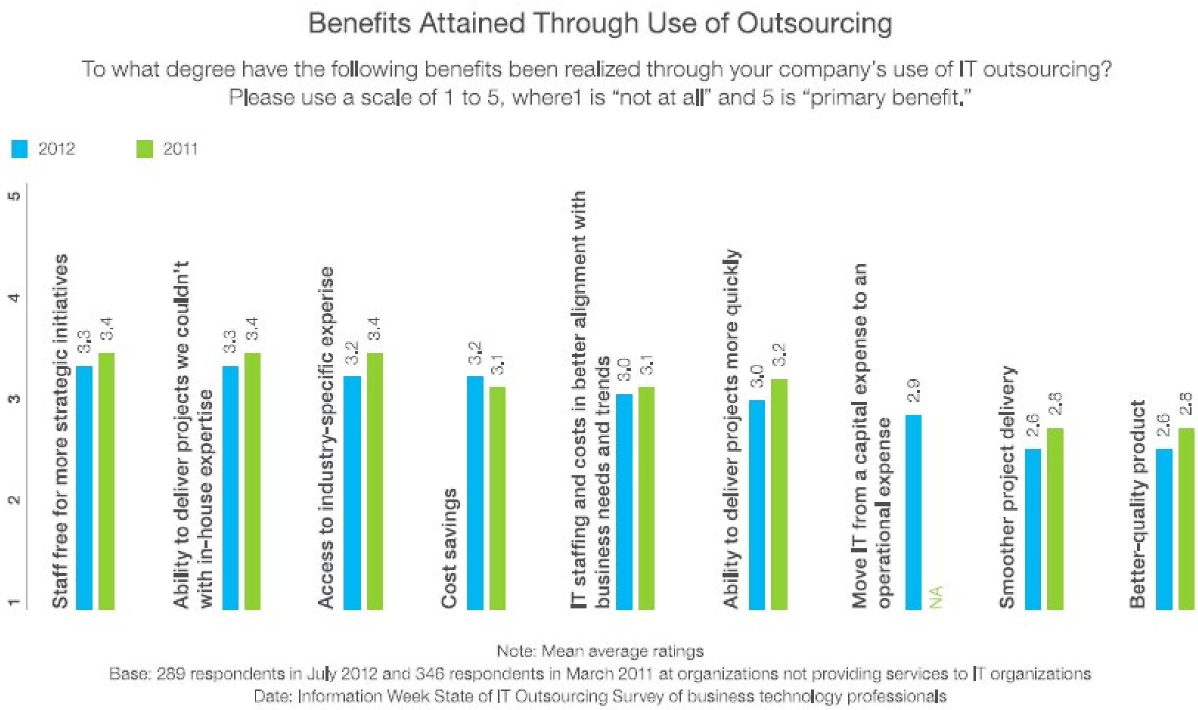
Merchant acquirers that decide to use outsourcing to help them implement one or more of the strategies designed to combat the pressures on margins and share in the industry will need to choose their outsourcing partners carefully. Ideally, the merchant acquirer should seek an outsourcing partner that derives most of its success from the merchant acquiring industry.

That organization should also do more than simply deliver projects. To compete successfully the merchant acquirer needs a partner with a vertically integrated approach to delivering what is required for the overall business. Finding an organization that can provide the necessary skills, knowledge and

17 The State of Outsourcing in 2012, Information Week, 2012.

resources required to gain the greatest advantage in the marketplace will require a careful search for the right focus and level of expertise.

Most of the large outsourcing organizations have skills in payments that are very broad – but lack deep, payments-specific skills. Therefore, the role of vertically integrated expertise in payments becomes important for merchant acquirers to achieve timely solutions. Each merchant acquiring company will need to make its own judgment based on their specific needs. For many organizations the choices made now will determine whether the future will be the best of times or the worst of times.



RS Software, the sponsor of this report, is a company of 1,000 resources focused specifically on the merchant acquiring space. For more than 20 years, RS Software has served this space with a vertically integrated approach to providing solutions to many of the leading brands in it.