Five imperatives for navigating turbulence in the payments ecosystem

How merchant acquirers can evolve from financial utility to technology partner

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A storm of innovation in technologies and business models is shaking up how consumers make, and businesses receive, payments. Large technology firms and digitally based start-ups have launched a slew of new products and services that threaten the established profit pools controlled by banks, the card networks and merchant acquirers.

This upheaval looks set to accelerate in most countries and among every customer segment. Payment companies will have to embrace the disruption or suffer the fallout. Well-prepared and adaptable merchant acquirers can turn the disturbance to their advantage—that is, if they can meet the following major challenges:

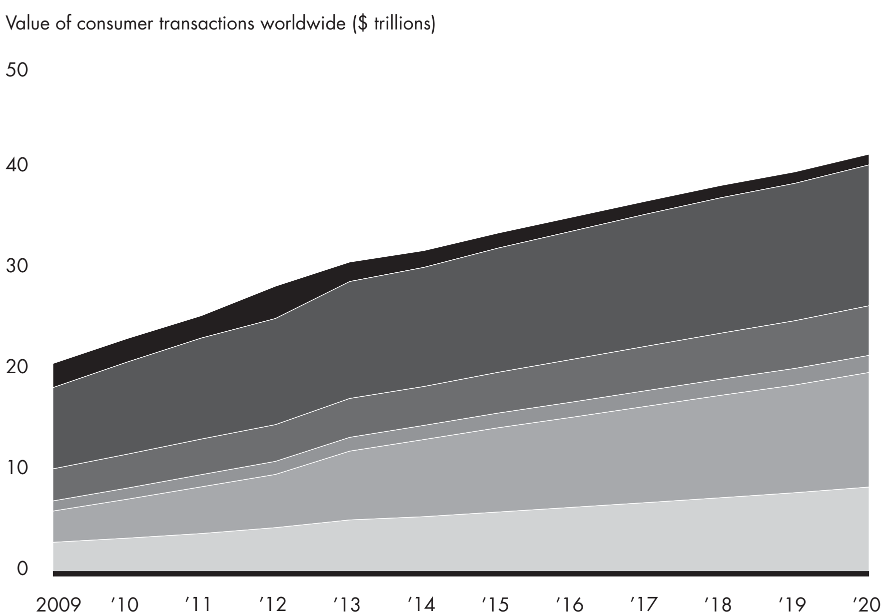
- Retain control of the merchant-consumer payment interface.
- Provide tailored, segment-specific propositions.
- Strengthen proprietary distribution channels.
- Embrace new payment types beyond cards.
- Determine how to monetize collected data.

Merchant acquirers enable business customers, known in the industry as merchants, to accept payment via cards and increasingly through online payment systems such as PayPal and Klarna or new card-based mobile wallets such as Apple Pay (see sidebar, "Merchant acquiring: Business fundamentals").

Success hinges on making the cultural and organizational shift from being a financial utility provider to a technology-focused partner. In this new role, acquirers support their customers in selling more, reducing costs and adapting to the fast-changing payments environment. Those acquirers that are unable or unwilling to evolve and innovate risk slipping into low-margin, commodity activities.

Despite the challenges, there are reasons for optimism. Payments represent a rich and growing profit pool with relatively low capital requirements—a rarity in financial services. Electronic transactions continue to show strong growth, taking share from cash payments in all regions worldwide (see Figure 1). Debit and credit cards remain the largest noncash payment mechanisms, and for acquirers, the emergence of Apple Pay, Android Pay and

Figure 1: Consumers have embraced noncash payment methods



	CAGR 2009–2015	CAGR 2015–2020
Total	8%	4%
Other types of paper payments	–8%	–7%
Cash	7%	3%
Electronic/ACH	4%	4%
Other types of card payments	6%	3%
Debit card	18%	6%
Credit card	12%	7%

Note: Estimates for 2015–2020
Sources: Euromonitor data; Bain analysis

the like, underpinned as they are by card infrastructure, signal that this trend will likely continue in many of the largest country markets.

Online payments, including conventional e-commerce and mobile commerce, continue to post the strongest growth *(see Figure 2)*. This benefits acquirers with strong capabilities in online payments, where profit margins tend to be higher, in part because the business usually comes with a wider range of value-added services such as fraud risk management.

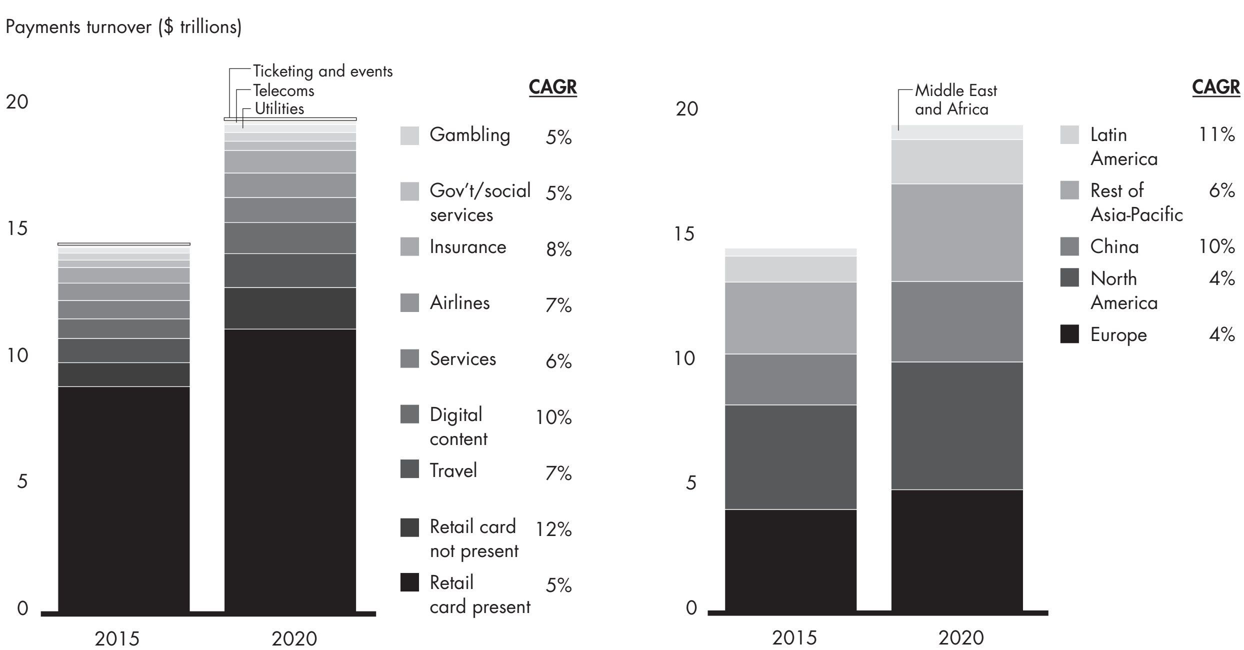
From a geographic perspective, acquirers exposed to emerging markets will see greater growth and lower competition, and thus have a greater ability to defend their margins. However, even highly mature markets in Europe and the US should show solid growth, particularly in online retail and digital content.

Regulatory developments also present opportunities for acquirers. For instance, regulators have continued to push hard on interchange fee levels, most recently with the European Payment Services Directive II. Caps reduce interchange, the pass-through element of the merchant service discount revenue paid to card issuers; if the caps get passed on to merchants, this could result in lower costs of acceptance and should encourage greater card acceptance.

How individual acquirers fare in fending off the threats and capitalizing on the opportunities will depend on how effectively they address five specific challenges:

1. Avoid disintermediation by controlling the payment interface and the merchant relationship, which is underpinned by flexible technology.
2. Deploy a practical customer segmentation scheme and tailored propositions, because one size does not fit all.
3. Protect diverse distribution channels and access to new channels, and raise channel productivity.
4. Embrace new payment types, remaining agnostic where possible, to meet consumer and merchant needs.
5. Defend valuable data, and plan to monetize that data.

Figure 2: Forecast growth varies by industry and region



Sources: Euromonitor data; Bain analysis

Challenge No. 1: Avoid disintermediation by controlling the payment interface and the merchant relationship, which is underpinned by flexible technology.

For both domestic and global customer segments, ownership of the merchant-consumer interface has always been (and remains) essential for an acquirer to avoid merely providing commodity services. Acquirers have historically operated in both transaction capture/payment gateway and pure acquiring markets, renting point-of-sale (POS) terminals to smaller merchants and providing e-commerce gateway services. This has allowed them to control the full merchant relationship and, therefore, capture the end-to-end profit margin.

The dynamic is changing, however, as new entrants target the interface with the merchant, potentially wresting control, relegating acquirers to the status of commodity providers and capturing the lion's share of the profit pool for themselves. In mature markets, large domestic corporate merchants took control of their payment interfaces many years ago, and competition for their pure acquiring business became price-based, resulting in near-zero acquiring margins on the largest domestic merchants.

In the US, the most advanced market with regard to the merchant-consumer interface, innovation has blossomed in both physical and digital gateways, primarily led by newer, nimble companies that are unencumbered by legacy IT systems and that target both large corporations and small and medium-sized enterprises (SMEs). For example:

- Independent software vendors and value-added resellers work with small and midsize merchants, often in a targeted industry, to provide POS solutions bundled with payments acceptance. They strike deals with preferred acquirers and thereby capture some of the acquirer's profit margin.

- Clover, from acquirer First Data, aims to displace smaller merchants' traditional POS terminals with tablet-based solutions that integrate payment capabilities with broader business management functionality.

- Square provides a simplified, bundled service to very small firms. It uses a traditional acquirer, Chase Paymentech, on the back end and receives a cut of the revenue from the acquiring stream.

- Stripe and Braintree, both of which are dynamic e-commerce and mobile commerce gateways, offer a simple sign-up and easy integration for software developers.

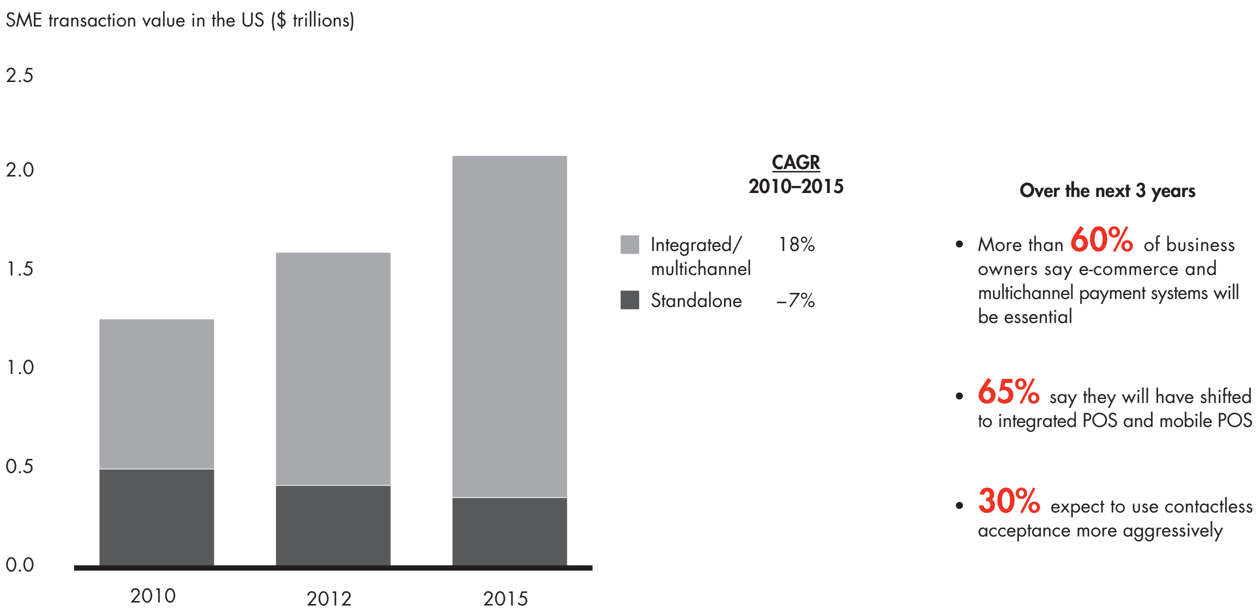
SME markets are developing at different rates. In the US, integrated POS solutions have already pushed out traditional standalone POS terminals *(see Figure 3)*. In Europe, Latin America and Asia-Pacific, acquirers retain control in domestic transaction capture/payment gateway markets—for the moment. Acquirers with well-developed distribution to small businesses have a brief opportunity to expand beyond their traditional role of enabling payments. By integrating payments with simple, easy-to-use POS offerings, they can provide solutions their merchants seek and defend their margins.

Businesses increasingly look to technology providers for a payments solution integrated with other components of hardware and software. This hands an important distribution role to the software vendor or technology reseller—or, in the online world, to the Web developer. Commercial success with technology distributors requires a different set of capabilities for today's acquirers, including ease of integration and the ability to serve up a portfolio of products, such as payroll functionality, that can easily integrate into a broader software stack through cleanly written application programming interfaces (APIs).

These developments have been playing out even faster in the realm of e-commerce. Here, payment gateways bridge a retailer's website with the broader payments ecosystem. Moreover, the flow of data through these gateways allows these providers to give customers a view into their business performance and to improve their marketing and loyalty programs.

Globally, winning acquirers will retain control of the payment interface by providing real value to customers and cutting through the complexity with simple, compelling solutions. Acquirers with critical scale in pro-

Figure 3: US merchants continue to shift from basic standalone terminals to advanced payment systems



Sources: Bain SME Merchant Surveys

cessing and distribution have a strong position from which to encourage adoption of these solutions by their customers, retain control over their profit pools and respond to changing regulatory requirements.

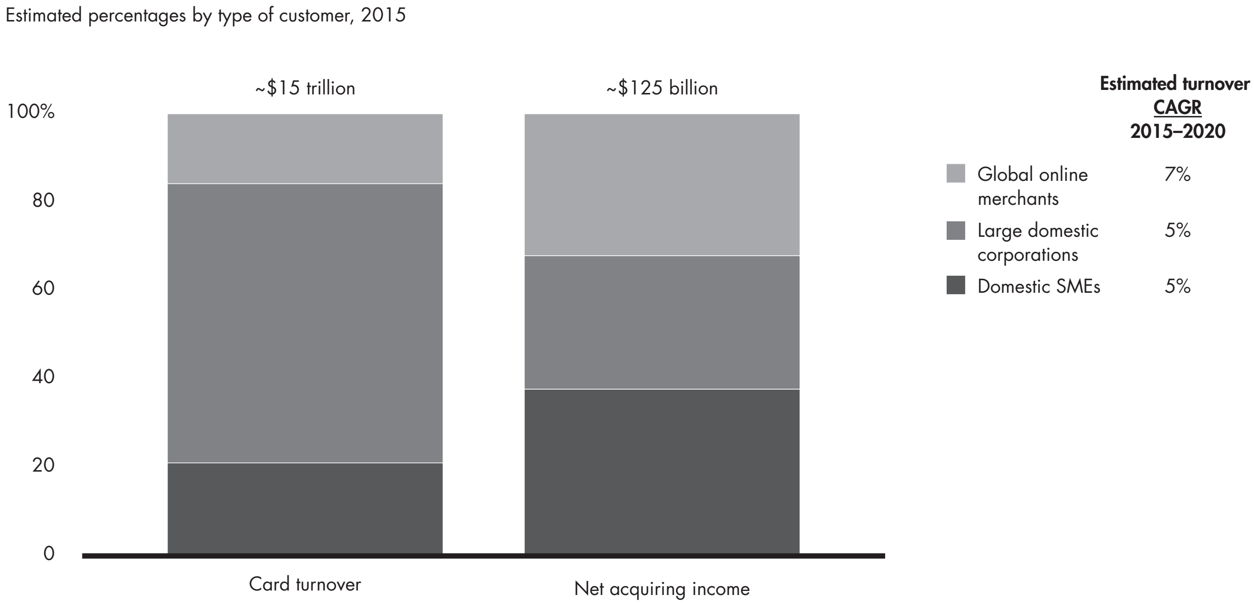
Challenge No. 2: Deploy a practical customer segmentation scheme and tailored propositions, because one size does not fit all.

For merchant acquirers, serving distinct customer types—large domestic merchants, domestic SMEs and global online merchants—entails quite varied starting points, meeting different priorities and dealing with separate competitive pressures. Figure 4 illustrates the crucial differences in economics among the three most important segments. For independent acquirers, large domestic corporate customers, despite representing about 60% of global card turnover, command only slim revenue yields—in some markets, even negative yields when cross-subsidized by sales of other banking products. Global online merchants and domestic SMEs constitute much richer revenue pools.

Global online merchants comprise the fastest-growing segment in industries such as airlines, travel, digital content, gaming and gambling, and global retail. These companies have complex needs; they want a single primary provider that offers consistent service across multinational payment acceptance, a broad range of local payment types beyond cards, sophisticated fraud management and acceptance maximization services. In contrast to large domestic merchants, even the largest global online merchants generate attractive margins because they buy based on the quality and depth of the solution and the strength of their partnership with the payment provider.

Large domestic corporations often do business through multiple sales channels. They tend to use acquirers for pure processing and buy the transaction capture/payment gateway from third-party systems integrators or develop it in-house. This has been a high-volume, low-margin business based on price and reliability. Successful acquirers deliver value through reporting and custom analytics to help run the business, expanding payment methods and, more recently, supporting large retailers' attempts to

Figure 4: Revenue yields for global online merchants and domestic SMEs exceed those for domestic corporations



Note: Estimated revenue yields include net acquiring income (merchant service charge minus interchange paid to issuers) and income from payment capture services
Sources: Euromonitor data; Bain analysis

offer consumers a seamless experience across their websites, mobile apps and physical stores.

Domestic SMEs, by contrast, are the engine of domestic acquirers' profits. In the most developed domestic markets, such as the US and UK, 80% of profits are generated on only 20% of the volume. Historically, acquirers treated SMEs' needs as homogenous. They wielded distribution power and were content to offer SMEs generic payments terminals and acquiring services. Acquirers focused on bank partnerships, affiliate agreements, and (less profitably) independent sales organization relationships.

Almost half of small businesses in the US report having an online or multichannel presence, and they represent a particularly attractive opportunity for domestic acquirers. Remarkably, many acquirers have not yet merged their online and POS products into a single solution, so multichannel merchants have to endure multiple financial reconciliation processes, different support teams and difficult access to integrated payment management information. Acquirers that can cut through the complexity of their own legacy IT systems to provide a single payments hub that integrates data, pricing and functionality across all channels will help their merchants to reduce costs and increase sales.

New entrants are offering more sophisticated, tailored solutions. They recognize that a multi-outlet, multichannel retail company requires consolidated management information and support for complex reconciliation of payments with bank statements; it might also desire tablets as sales tools that integrate payments functionalities. An owner-managed business with a single physical store, by contrast, likely does not need or want those services.

As US acquirers have ventured into the POS development and supply business, many also see the value in segmenting merchants based on business type. For example, a pizza parlor that depends primarily on takeout orders will need a different workflow and functionality than a high-end restaurant.

Acquirers can earn the right to more of their customers' business by dramatically simplifying the experience—for a start. Instant account creation and sign-on, self-serve portals, rich reporting and transaction reconciliation, and automated charge-back management all have proven valuable to merchants, yet they continue to be the exception rather than the rule in most countries. The dramatic rise in capability acquisitions signals that forward-thinking merchant acquirers have realized they must build such capabilities and, in the US market, actively enter the POS development business.

Micro merchants have seen a proliferation of solutions aimed at increasing card acceptance. Led by Square in the US and iZettle in Europe, new entrants have launched simple, low-fixed-cost solutions based on a card-reading device tethered to a smart phone. Despite rich pricing (typically starting at 2.5%–3% of transaction value), the low volumes per merchant and high acquisition costs have made it tough for providers to turn a profit. Square has expanded into new products and segments to find new sources of income, and many other providers have yet to break even.

For each customer type, and especially for domestic SMEs, treating customers as homogeneous in their needs no longer works. Acquirers will have to develop more tailored solutions in order to compete effectively with third parties and new entrants.

Challenge No. 3: Protect diverse distribution channels and access to new channels, and raise channel productivity.

In the large corporate segment, success will continue to involve sales organizations that exhibit a deep understanding of their customers' priorities, no matter how quickly technologies evolve.

Within the SME segment, many acquirers could stand to strengthen their basic go-to-market muscles. Indeed, we consistently see classic improvements to channel performance, ranging from salesforce effectiveness to lead generation and price optimization, adding significant value. Though bank partners remain a valuable channel, acquirers should develop a broader set of their own effective lead-generation and sales capabilities. Three years ago, Bain research in the UK found that 95% of SMEs chose the first provider to which they spoke, highlighting the value of being first through the door. This proportion has diminished, as merchants rely more on Internet searches to investigate their options and shop around, which means that acquirers should develop a strong digital footprint and convenient application and onboarding processes. In addition, an outbound sales and marketing capability using available lists and databases has become an important channel capability.

The fundamental dynamic, however, remains: Busy merchants want a fast and easy sales process, so getting the basics of the sales approach right across face-to-face, phone, partnership and digital sales channels is critical.

In the e-commerce world, developers or integrators have long been an important go-to-market channel for acquirers; the US market has demonstrated that with the shift toward integrated POS systems, developers or integrators are also becoming critical for POS and multichannel merchants. Witness Heartland Payment's acquisitions in the higher education industry and Vantiv's acquisition of Mercury. These firms are betting on increasing distribution to large portfolios of merchants with which they already have a relationship. They and other US acquirers have already had to react to marketplace shifts; acquirers in other markets have a chance to be proactive, but they must first decide how they will participate.

Challenge No. 4: Embrace new payment types, remaining agnostic where possible, to meet consumer and merchant needs.

How consumers pay is changing at the fastest rate since the proliferation of cards in the 1980s, as new card form factors and non-card alternatives gain steam. Consumers increasingly expect to switch channels to suit the context of the moment—start a purchase online, complete in store. The "card not present"/"card present" distinction now blurs as form factors shift and "convergence" payments expand—a consumer rides in an Uber taxi, but the payment flows remotely through stored card details.

Mobile wallets may finally come of age as big technology firms launch new or rejuvenated wallets that change the card form factor from plastic to smartphone. At face value, this benefits acquirers, although underlying tokenization technology might render valuable data streams unusable, because acquirers see encrypted tokens, not in-the-clear consumer card data. Other new methods including cryptocurrencies, while still a niche market, also have grown.

It is too early to say which of these initiatives will ultimately succeed. Apple Pay, for instance, launched just a year ago in the US and still represents only a tiny fraction of consumer payments there. Consumers appear willing to try the new form factor, and given the short life cycle of mobile handsets, a critical mass of compatible handsets could emerge in the next two years. But how many merchants will participate?

Apple Pay launched in the UK in July 2015, and here consumer interest in the payment method may be high. The European Payment Services Directive II caps credit interchange fees at 0.3% and debit fees at 0.2%, which reduces the likelihood of merchants holding out for interchange-free alternative payments, and the existing 250,000 or so contactless terminal estates will also support usage (including London public transit). Actual consumer adoption, however, remains to be seen.

Non-card payment methods also have risen. Real-time account-to-account payments are now possible in a number of markets, including the UK, Singapore and Denmark. Zapp, a mobile payments start-up formed by UK payments infrastructure operator VocaLink, has signed up major retail chains to let customers make real-time payments directly from their bank accounts with their mobile phones. Zapp has to convince consumers of its value relative to cash and debit cards, however, and it has to convince merchants to invest in acceptance without the impetus of high interchange fees. MCX in the US, a joint venture of Walmart, Best Buy and other large retailers, offers a similar proposition that is motivated by a desire to circumvent stubbornly high interchange levels.

In the online world, non-card payments have long been necessary. The most successful payment providers to sophisticated global online merchants compete to provide a complete range of alternative payment types; the strongest provide well over 200 individual payment methods. That breadth allows their customers to accept payments by any method anywhere in the world. One critical aspect of the proposition, then, is providing a simple, integrated solution to the bewildering complexity of global payment types.

At the physical point of sale, cards likely will remain dominant over the next five years, but the form factors will change and the dynamics of each country's market can vary significantly. The uncertainties mean that acquirers should remain agnostic on payment methods, facilitating rather than fighting non-card methods. In fact, the complexity that merchants face offers an opportunity for acquirers, which can step up to the role of an intermediary that makes sense of the confusion of multiple settlements and simplifies life for their customers.

Challenge No. 5: Defend valuable data, and plan to monetize that data.

Beyond the provision of payments services, many participants in the payments ecosystem regard payments data as a huge seam of gold waiting to be mined. At a minimum, business intelligence and data analytics can significantly reduce customer churn. Knowing in real time where and when consumers spend money has enormous intrinsic value, and data represents perhaps the greatest latent opportunity for acquirers to capture more value through innovative services.

Other companies in the value chain have used data to their advantage. Visa has been working on card-linked offers with merchants. Capital One has used data to market to consumers for years. Yet despite having the deepest relationships with the merchants that stand to gain the most from data propositions, acquirers have not yet been able to unlock the value of their data. To do so, they will need to address several issues.

The first is protecting their access to the data itself. Tokenization threatens to nullify some aspects of the information they see—that is, if they can no longer identify consumers by their card numbers that get replaced by tokens. Also, the card schemes themselves seek to create direct merchant relationships. From an economic perspective, large domestic merchants tend to generate little profit for acquirers; however, many of the potential data propositions require access to large volumes of transactions. If bypassed, acquirers may forfeit that potential stream of value.

The second issue is identifying which propositions to offer, to whom and at what price points. How can acquirers turn data into a product for which retailers or other businesses would actually pay? What partnerships with other data sources could enrich the offering? Compelling cases include several ways of helping merchants:

- **Sell more.** Profiles of consumer spending patterns could show a merchant where else a merchant's customers shop. Notifying merchants of a valuable repeat customer in their store, identified by a card number, could trigger tailored offers or interactions.

- **Reduce costs.** Analysis of interchange incurred could highlight opportunities to reduce costs, as when outlets process too many expensive magnetic stripe transactions in chip and personal identification number markets.

- **Make better decisions.** Analysis of local sales data could support merchants in deciding where to open the next store. Providing real-time data on retailer performance could be valuable to financial investors.

To be sure, questions of data ownership have to be resolved, but acquirers likely have as much right to the data as banks and card schemes.

The third major issue concerns execution. Despite being data-intensive businesses, few acquirers have deep analytical expertise. Merchant acquirers will need to prove out the demand before making a significant investment.

Think technology partner, not financial utility

The financial utility model no longer generates value in payments markets. Instead, winning acquirers are evolving to become true business partners with their customers by helping merchants sell more, reduce cost and create better experiences for consumers.

This new model requires developing a new culture, one similar to a successful technology company. The culture should prize innovation, alongside the traditional values of stability and security, so that an acquirer can rapidly develop propositions that will stand out in the eyes of its target customers. Most acquirers have legacy systems, and winning acquirers will manage through this issue, either by investing in reengineering their core systems or by creative use of translation layers and APIs over the underlying platforms.

To help assess a company's current competitive position and how it should proceed, executives can ask themselves a set of questions:

- How will you adapt your organization, culture and capabilities to evolve into a technology-led partner for your merchant customers? Bridging this gap is particularly important for bank-owned acquirers, which find it hardest to adapt.

- Are you clear on your target customer segments and the differentiated propositions you will provide to win or retain their business? How strong is your plan to maintain ownership of the customer payment interface?

- What is your stance toward non-card alternative payments? Are you embracing the opportunities offered?

- How much extra value can you extract from being brilliant at the basics, such as a highly efficient sales process, best-in-class sales/onboarding experiences and broader channel strategy?

- How are you protecting and monetizing your data?

If the answers to a number of these questions cause concern, then it could be time to revisit the business model to ensure it can adapt to the upheaval now under way.

Merchant acquiring: Business fundamentals

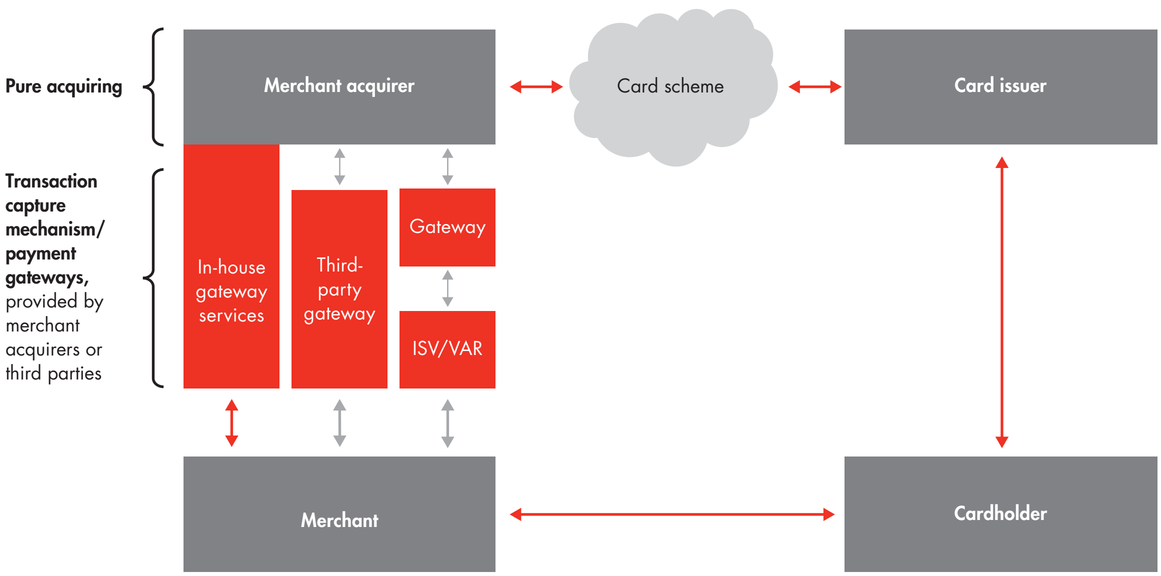
The process of enabling merchants to accept payments involves two distinct value-chain steps, with different requirements for success. Merchant acquirers typically participate in both steps.

- **Transaction capture mechanisms and payment gateways:** Terminals and Web payment pages collect payment details from consumers and connect merchants to the acquirer—that is, the payment interface between a merchant and their consumers. Gateways are technology platforms that connect the many types of online and physical transaction capture mechanisms to the acquiring ecosystem, and they add functionality and services to merchants.

- **Pure acquiring** is the routing of transactions from the gateway to the appropriate card scheme, such as Visa or MasterCard, for authorization by the card-issuing bank and subsequent clearing and settlement of transactions so that merchants receive payment for their transactions. Acquirers bill merchants a service charge to cover interchange and other costs, as well as the acquirer's profit.

In both steps, providers can offer other services, including fraud and risk management, currency and treasury services, and tokenization (for securely storing consumer card details on behalf of merchants to allow easy repeat and recurring payments).

The card payments value chain



Note: ISV/VAR is independent software vendors/value-added resellers
Source: Bain & Company

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