Is This the End of Merchant Acquiring?

While undoubtedly changed, the payments industry isn't dead. Here's why.

By Mike Strawhecker

When reading and hearing some recent comments from Wall Street analysts and media outlets on the payments industry, Mark Twain's famous remark, "Reports of my death have been greatly exaggerated," comes to mind.

For example, following the cancellation of the WorldPay auction, Reuters reported, "Once a lucrative sector, payment processing has come under pressure from increased competition and technological change that has seen many companies struggle to retain their customers and maintain their pricing models" ("Bain, Advent Cancel Sale of WorldPay's U.S. Unit," May 2013). This theory was supported by citing the TransFirst and First American Payment Systems cancelled auctions, as well as First Data's apparent shopping of its financial services business.

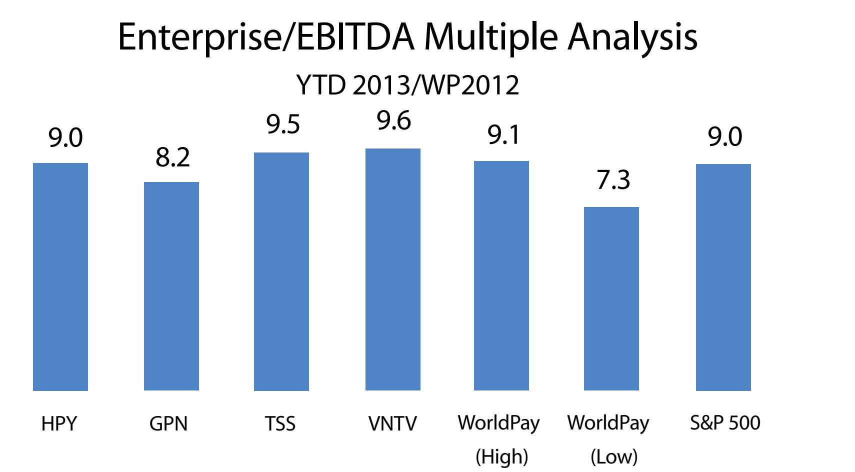
While the emergence of new merchant acquirers (i.e., Square) has no doubt altered the industry ecosystem and increased competition, the insinuation that WorldPay, TransFirst, and First American Payment Systems cancelled their auctions because of the influence of these new players is quite a stretch. Reuters assumes that all payments companies are exposed to the same competitive threats and that those valuations are strictly based on sector attractiveness. This is inaccurately painting the entire industry with a broad brush. The fundamentals of the payments industry remain strong and the industry continues to be an attractive sector for investment.

Why WorldPay Cancelled

It seems simple, but sometimes a reminder is needed: It takes two agreeing sides to make a deal. The following factors—estimated using data from the Reuters article—may have led WorldPay to cancel the auction (see chart below):

- Bidders were likely below the low end of the offer range near $800 million, equating to an EV/EBITDA multiple of 7.3 times, which is well below current market valuations.
- The average multiple of the public payments companies listed in the chart is 9.1 (HPY, GPN, TSS, VNTV), the same as the high multiple of WorldPay. Unless given no other alternative, a seller would not settle for less than market.
- Bidders' growth projections may be more conservative than that of the seller, leading to a lower multiple and a difference in agreed upon value. This is one of many drivers that are unknown.

Ultimately, and most importantly, it would seem that WorldPay's ownership saw more value in retaining the asset than other reinvestment alternatives. The fact that they did not sell at a 7.3 multiple indicates ownership is confident in WorldPay's future performance. If the owners had sold at a 7.3 multiple, it would have supported the argument that "the best days in payments are gone," given that the owners did not see a positive future for WorldPay.



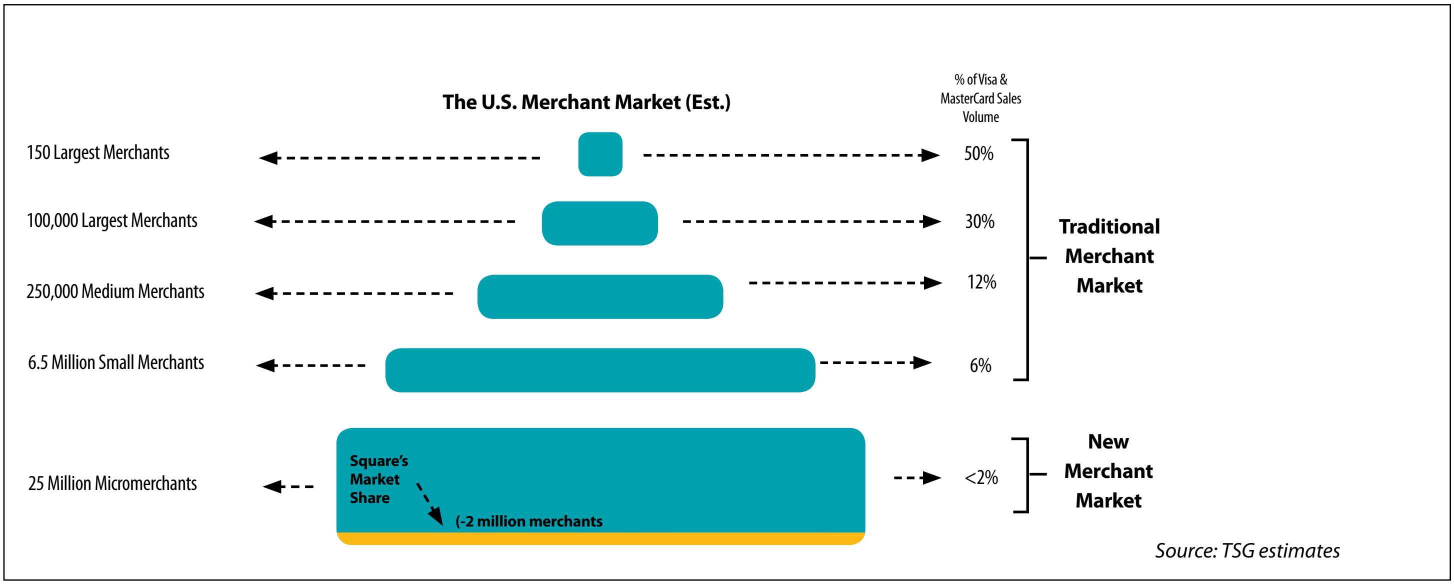
Source: TSG Metrics, Yahoo! Finance, InFinancials.com, Reuters, S&P 500

Square, a Threat?

Over the past two years, there has been no topic more discussed in the payments industry—except, perhaps, for Sen. Dick Durbin (D-Illinois)—than Square. Some of this notoriety undoubtedly comes from the Jack-Dorsey-created-Twitter effect and the inherent media platform that it provides. However, Dorsey's contribution to the industry has been profound indeed. Some companies, such as PayPal, had already simplified acceptance, and some, such as ProPay, had the technology. But Square combined these two ideas and marketed its product to the masses of micromerchants. Does this mean Square is a threat of disintermediating traditional merchant acquirers as some analysts have opined? It depends.

In a price-neutral scenario, the threat of disintermediation to acquirers depends primarily on four factors: merchant size, distribution, product, and vertical focus.

- Merchant size: The smaller the average merchant size within a portfolio, the higher the risk of disintermediation as this is Square's sweet spot in regard to boarding and pricing a merchant. At



present, Square's average merchant processes less than $5,000 annually versus the small- and medium-sized business (SMB) acquiring market average of $166,000, according to data from The Strawhecker Group's (TSG) SMB merchant database of 1.6 million merchants from 11 portfolios. Additionally, micro/aggregated merchants experience loss rates that are on average roughly 70 times higher than the market average; the typical merchant portfolio has a diversified concentration of merchant sizes and types.

- Distribution: Acquirers with a more generic offering and a heavy reliance on non-integrated distribution may be more exposed to the disintermediation threat than others. However, Internet and retail store-based distribution models will likely be difficult to successfully execute outside of the small/micromerchant market; larger merchants are more likely than their smaller merchant counterparts to demand levels of customer service associated with a dedicated sales agent/point of contact.
- Product: Trends in acquiring have moved from payments being the only product sold to payments being packaged with other "business management" products. ISOs and acquirers with niche payments solutions tailored to a specific merchant vertical or integrated through business management software typically experience higher retention rates due to high switching costs (and difficulty of switching) among their merchant clients.
- Vertical focus: ISOs and acquirers servicing merchants that lack the need for a tailored solution or a software integrated solution are likely more exposed to price competition than their specialized counterparts due to lower switching costs. It is likely that the vast majority of these merchants do not exceed a certain size in annual volume; the larger a merchant is, the more it will need and benefit from a specialized or integrated solution.

The threat to merchant acquirers is drastically different based on the makeup of their portfolios and how they provide their services. Is the influence of companies like Square affecting auctions of payments companies, as some are arguing? Given the data on the chart, one could argue that it shouldn't be. This is the case because the majority of Square's merchant base primarily comes from an entirely new card-accepting merchant market.

A New Market

The U.S. card-accepting merchant market was once estimated at 7 to 8 million merchants. With the emergence of Square and other companies, the potential card-accepting market now includes more than 20 million micromerchants on top of the previously accepting card market of 7 million, as the chart above shows. Square's influence has been immense in that it helped create a new card-accepting micromerchant market. With this new market, merchant acquiring is not a zero sum game.

For example, according to data collected by TSG, gross dollar volume attrition for merchants with dollar volume from $0 to $25,000 annually actually decreased from -31 percent to -24 percent during Square's rollout and subsequent growth period from July 2010 to December 2012, which strongly suggests that Square is not taking its share from incumbent acquirers.

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Despite the opinion of some outside the industry, the payments industry continues and will continue to be a dynamic, attractive, and growing market built on a recurring revenue model and the increased usage and acceptance of electronic payments. ***TT***

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