EXECUTIVE INSIGHTS

Untapped Opportunities in Billing Payments: Is Market Complexity a Barrier to Disruption?

Over the past decade, technological advances have created new ways to pay for goods and services, and consumers now expect their transactions — whether in person or online — to be secure, efficient and frictionless. This has pushed merchants to evolve their payment processes and created needs that traditional financial institutions have struggled to fulfil, resulting in space for technologically innovative payment processing providers to thrive and prosper.

Payments in the fast-growing ecommerce space have seen a huge amount of innovation, and now the more traditional 'billing' space is ripe for disruption. At the same time, there are systemic and behavioural challenges facing market players wanting to succeed in this space. This article examines the current environment for payment processors and discusses the advantages and challenges they face in realising their potential in this part of the fintech market.

Payment processors act as intermediaries between merchants, customers and financial institutions to facilitate the transfer of funds during transactions. Their role in the payments ecosystem has increased considerably: the success of Square and Stripe shows how disruptive fintechs, focused on innovating to address merchant needs and eliminate pain points, can run rings around banks that remain stuck in their traditional lending business practices. However, while this disruption of in-store payments and in the ecommerce space has been very visible, there is another interesting area — billing — that is often overlooked.

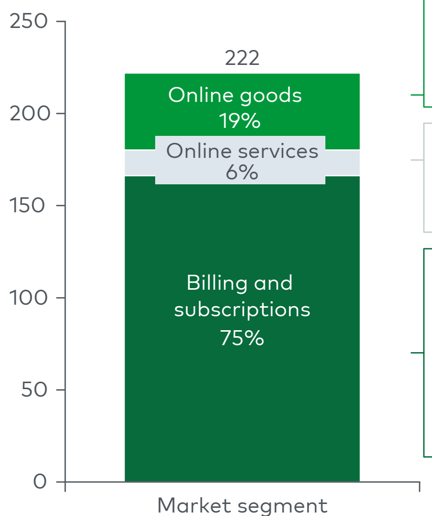
Ecommerce vs billing

Ecommerce transactions typically involve one-time purchases of goods or services, with payment taken by the merchant at the time of ordering — think of your latest Amazon online shopping order. Conversely, there is a group of merchants — the 'billers' — where payments are not as directly linked to the provision of the goods or services. These include rental agencies, utilities, private schools, day care providers and gyms, among other examples. Billers often ask customers to pay in recurring instalments or in arrears (and sometimes both) and because of this they have a different set of payment processing needs compared to ecommerce merchants.

Many of the most recognisable fintechs in the payments space are focused on ecommerce transactions, but billing payments are far higher in value and volume. Looking at online card transactions (card-not-present transactions) only, L.E.K. Consulting estimates that in Australia billed or invoiced payments account for approximately 75% of total transaction value — or over $165 billion AUD — compared to only 25% for one-off purchases of goods and services.

Figure 1

Value of Card-Not-Present transactions in Australia by merchant category



Merchant categories

1. **Online providers of one-off goods**
   e.g. F&B retailers, furniture, hardware, clothing and beauty, electronics
2. **Online providers of one-off services**
   e.g. airlines, accommodation, ride sharing, events
3. **Subscription services**
   e.g. media and entertainment, meals, repeat goods purchases
4. **Billers**
   e.g. utilities and telcos, insurance, tolls, public transport, schools, government fees, gyms

Note: CY=calendar year; F&B=food and beverage
Source: L.E.K. Research

Furthermore, this perspective underestimates the real size of the billing segment as it doesn't capture payments made via BPAY or direct debit or direct manual payments made by customers using a merchant's BSB and account number on individual invoices. The size of the billing segment, coupled with the differences in merchant needs, makes it an exciting part of the market for new fintech entrants (and their investors).

A compelling value proposition for merchants

Currently, for most bills paid online, customers make payments by logging into their online banking and manually entering invoice details. The multi-step effort of doing this results in customers making late payments or forgetting to pay altogether, impacting merchants' cash flows and forcing them to work out who the non-payers are to chase them for payment. Even when a customer pays on time, the merchant incurs effort and cost in reconciling payments against issued invoices at month-end, especially when customers make errors in entering invoice details.

Payment processors offer billing merchants a compelling value proposition that helps them address these pain points (and more) through the orchestration and administration of payments, as well as also by acting as a payments facilitator

Orchestration – rather than merchants having to rely on customers to initiate a payment (e.g. via their online bank account) payment processors can enable merchants to more actively 'pull' a payment. By aggregating together a variety of different payment methods to present to the payee, the payment is more likely to be made on time.

Administration – in addition to enabling a variety of payment methods, payment processors offer value-add functionality that sits between the payment gateway (the part of the ecosystem that enables the secure, capture, transmission and authentication payment information) and the merchants Business Management Software (BMS). Such functionality includes helping to manage recurring payments and processing chargebacks, as well as automating the tracking and reconciliation of payments, helping to eliminate manual and costly back-office accounting processes. Integration between the payment processor's platform and the merchants BMS is critical to delivering this functionality.

Payments facilitators (payfacs) – payment processors can also serve merchants by acting as a payfacs and intermediating between the merchants and the banks. By aggregating together many smaller merchants, payfacs achieve scale and get a better deal on payment interchange fees. Because payfacs focus purely on providing merchant services, rather than broader banking, they usually offer merchants better experiences in onboarding and ongoing service as compared to banks.

Strong drivers behind the billing sector's growth

L.E.K. has identified several promising factors in the billing sector which will help drive the growth of billing as a profitable segment in the fintech space:

The sector is growing fast but can grow further. L.E.K.'s research indicates that the added value provided by payment processors is driving rapid adoption, but there is still substantial headroom for further growth. Ignoring the impact of Covid-19, we estimate that the use

of payment processors by billers is growing at over 20% p.a. in transaction value terms — but even in the most highly penetrated verticals they still only account for c.25% of total billings.

New payment 'rails' will drive further adoption. The new PayTo service being introduced as part of Australia's New Payments Platform lets merchants easily pull a payment from a customer's bank account while avoiding the processing fees charged by Visa, Mastercard and the other card payment rails. This payment option will appeal greatly to consumers who currently prefer to make push payments, such as bank transfers, to avoid those card fees. Merchants will also appreciate the value in being able to pull the transaction to get the payments quickly and avoid time-consuming reconciliations at month end. However, to get these benefits, merchants will need a payments processor that can enable PayTo for them.

Transaction volumes and value are predictable and resilient. Billing merchants typically have predictable cash flows, especially when they are providing ongoing, less discretionary services — think school fees and utility bills — that aren't as impacted by economic cycles. The regular and recurring nature of the payments they take will in turn create predictable and resilient transaction values to be handled by their payments processor.

Retention of onboarded merchants is high. Payment processors in the billing space typically have a very high merchant retention rate. This is because merchants value a processor that is integrated with their business management software (BMS), as this helps automate the process of pulling payments and reconciling them, resulting in considerable back-office savings. As BMS providers are focused on developing their core software, they typically integrate with only a few (and sometimes only one) payment processors. Changing BMS providers is a complex and costly process for merchants, and because it happens infrequently, the stickiness of the BMS translates into stickiness for the integrated payment processor.

There is an opportunity for a disruptor to drive consolidation. Compared to the ecommerce space, payments processing for billing is much more fragmented, with many smaller providers (often with aging technology) occupying positions in one or two merchant verticals. Typically, both the banks and the ecommerce-orientated payment processors are less interested in this area:

- The banks' focus on their core lending businesses means their merchant services teams get less attention and resourcing. While banks do offer online payment gateways that can handle billing payments, these are not often integrated with merchants' BMS and do not provide the additional value a payment processor's platform can. Banks have shown little interest in proactively creating such integrations, preferring instead

to provide just the merchant acquiring via partnerships with third party payment processors and payfacs.

- Global ecommerce payment processors are more proactive but have focused on integrating with the big ecommerce retail platforms, and as a result have concentrated on ecommerce merchant needs more, such as fraud detection and quick approval speeds to maximise customer conversions and minimise abandoned baskets. Billing merchants need different functionality across their payment options, such as direct debit and the newer PayTo service, as well as integration with sector-specific BMS.

But there are challenges to overcome

However, while there are many attractive dynamics in the billing space, there are also some obstacles to greater disruption which successful processors will need to face and overcome:

Market fragmentation is a challenge as well as an opportunity. As discussed earlier, payment processing in billing is more fragmented than in other ecommerce areas, partly due to the difficulties faced by a single provider in operating across the extremely broad BMS landscape. This complexity is an obstacle to a payment processor trying to scale across different types of merchants using different BMS systems. One approach is for payment processors to use their existing integration with back-office software (such as accounting solution providers like Xero) that spans many merchant verticals.

BMS providers need incentives to work with new processors. BMS providers typically only integrate with a few payment processors, and sometimes just one. Merchants view payment processing as an important but commoditised piece of functionality for their BMS to have. BMS providers would prefer to avoid managing this themselves in-house but don't view adding payment processors as an improvement to their existing value proposition — they would prefer their development teams to focus on creating more differentiated functionality within their core offering. However, there are ways for payment processors to incentivise BMS providers to work with them, including commercial agreements for referral fees or revenue sharing.

And merchants need to be educated. Onboarding new BMS providers and growing the number of merchants that can be sold to is only the first challenge; payment processors still need to get those merchants to use and promote the platform. L.E.K.'s research shows that, even when merchants have access to an integrated payments solution via their existing BMS, uptake can still be patchy, with many continuing to use highly manual invoicing processes. The best-performing payment processors take a structured and proactive approach to merchant education by showing them how much value can be gained through improved recovery of receivables and lower back-office reconciliation costs.

Changing payee behaviours. Aside from the BMS providers and merchants, payment processors have a third and final set of stakeholders to deal with and influence — the customers themselves. Part of the reason that payment platforms still handle only a minority of billing payments is that consumers continue to pay in the same old ways despite the new options available to them. As they do with merchants, the best-performing payment processors actively promote their platforms to the consumer as a preferable payment option.

Larger enterprises are harder to break into. Large enterprises tend to be better served by their banks and have less need for a payfac; they also tend to have complex, bespoke enterprise software implementations which require a one-off integration of the payment processor. This, along with their complex internal procurement and technology processes, makes it harder for mid-sized payment processors to sell their services to these organisations. Larger enterprises can also better implement their own solutions to automate back-end payment reconciliation — reducing the value proposition of a third-party payment processor. While the advent of the PayTo service could help catalyse the broader use of payment processors by enterprises (with the payment processor providing access to that payment rail) in general, enterprise-level billers are likely to remain less fertile ground for payment processors.

A sector which continues to grow in potential — but with caveats

Billing as a sector will continue to grow, providing opportunities for innovative payment processors to consolidate and expand their market share. Successful operators will be those that can achieve this by taking advantage of the above factors to fully consolidate their operations and platforms and create innovation and disruption where they can. To do this successfully, they will need a full understanding of the highly complex ecosystem that lies behind the payment space.

L.E.K.'s experience in advising clients in this area shows that there are many attractive dynamics in the space; the downside risks look limited and there is substantial growth potential. However, while the space feels overdue for disruption, operators will need to understand the environment and its drivers to take advantage of these opportunities and ensure their investors are confident that they can be realised.

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