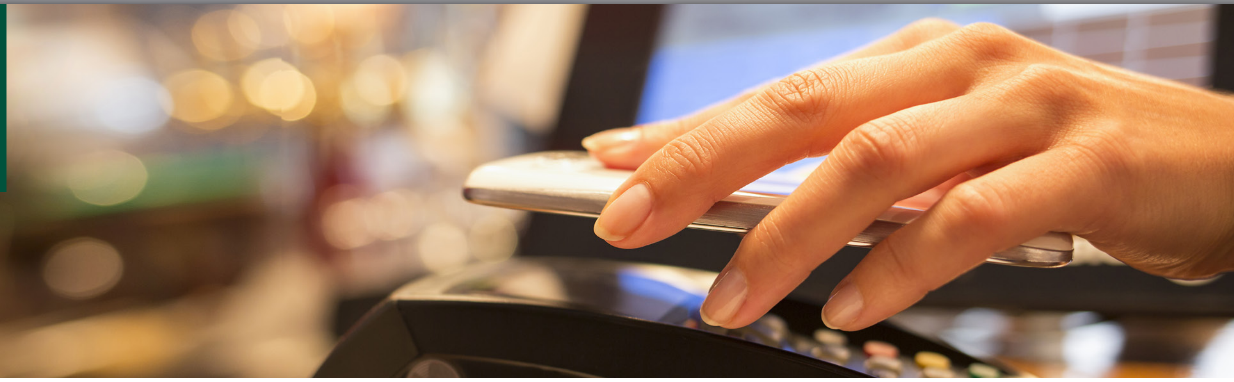

L.E.K.

EXECUTIVE INSIGHTS

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The Accelerating Payments Revolution: How to Manage Risks and Still Enjoy the Rewards

A Dynamic but Often Complex Market

The payments sector is in the middle of a revolution with new companies, technologies, and business models popping up at a steady rate. Investor interest is high, with five key trends generating attractive opportunities.

1. **The move away from cash.** This is building momentum as consumers and merchants increasingly adopt electronic payments. The shift, however, is far from complete.
2. **Increase in "consumer-not-present" transactions.** The growing use of mobile devices for commerce is driving higher volumes of consumer-not-present electronic transactions. These are often served by different players than those supporting point-of-sale transactions.
3. **Demand for multi-channel solutions.** Merchants are increasingly sophisticated about payments and require multi-channel solutions that provide seamless online check-outs.
4. **Growing cross-border commerce.** In-store experiences and increased flows of people (particularly from emerging markets into Europe) and international trade are driving growth in cross-border transactions and associated services.
5. **Disruption of existing business models.** New technology use (such as mobile phones at point-of-sale) has accelerated significantly, driven by a broader "fintech" trend in which new players are disrupting traditional financial services business models.

These five trends are producing opportunities and also complexity. The payments sector is extremely broad, encompassing the entire point-of-sale ecosystem for electronic payments as well as services related to consumer-not-present transactions and cash payments (see Figure 1), and the boundaries between different types of providers are blurring. Meanwhile, in emerging areas such as e-wallets and peer-to-peer payments, there are abundant new entrants, many with competing technologies. Their success will depend on creating major – and difficult to achieve – shifts in consumer and merchant behavior.

The industry is also being changed by regulators' attempts to increase transparency, drive innovation, and open the sector to broader competition. The Payment Services Directive II (PSD II), for instance, will enable third-party payment service providers to access data from traditional providers via open APIs. In addition, the European Commission has introduced new regulations proposing interchange fee caps (at 30 bps per transaction for credit cards and 20 bps for debit cards), among other measures.

Because of this complexity, late stage investors such as Private Equity (PE) may be inclined to avoid the sector altogether. The busiest payments investors are VCs and other early-stage

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Figure 1

Payments Value Chain and Competitive Landscape

Purpose of Payment	Source of Funds	Payment Method	Acceptance Platform	Payment Processing and Settlement
Purchase of Goods and Services – **Consumer Present**	• Banks • Credit Card Issuers • PoS Finance Providers	Card	• Till Hardware and Software Providers • Payment Terminal Manufacturers • PSPs	• Acquirers / Processors • Card Schemes
		E-Wallet e.g. Apple pay (mobile or wearables used as payment token)		• E-Wallet Providers
		Cash	• CHE Providers • ATM Manufacturers	• CHE / CIT Providers • ATM Networks
Purchase of Goods and Services – **Consumer Not Present**		Card	• Payment Gateway (PSPs / Acquirers / E-Wallet Providers, etc.)	• Acquirers / Processors • Card Schemes
		E-Wallet e.g. PayPal		• E-Wallet Providers
		PoS finance e.g. Klama		
		Bank Transfer / Direct Debit		• ACHs • Intl Payment Providers
P2P Payments		Cash or Cheque		• Money Transfer Operators
		E-Wallet		• E-Wallet Providers

Source: L.E.K. analysis

players who tend to be more comfortable with technology uncertainty. There are, however, areas of the sector with attractive opportunities and without excessive risk. These include situations in which PE firms have both experience and competitive advantages over other types of investors.

The Most Attractive Points in the Value Chain for PE Investment

There are four points in the payments value chain where investors can participate (see Figure 1):

1) Source of funds: Where do consumers and businesses access the money to pay?

2) Payment method: How do they pay?

3) Acceptance platform: How do merchants accept payments?

4) Payment processing and settlement: How are payments effected?

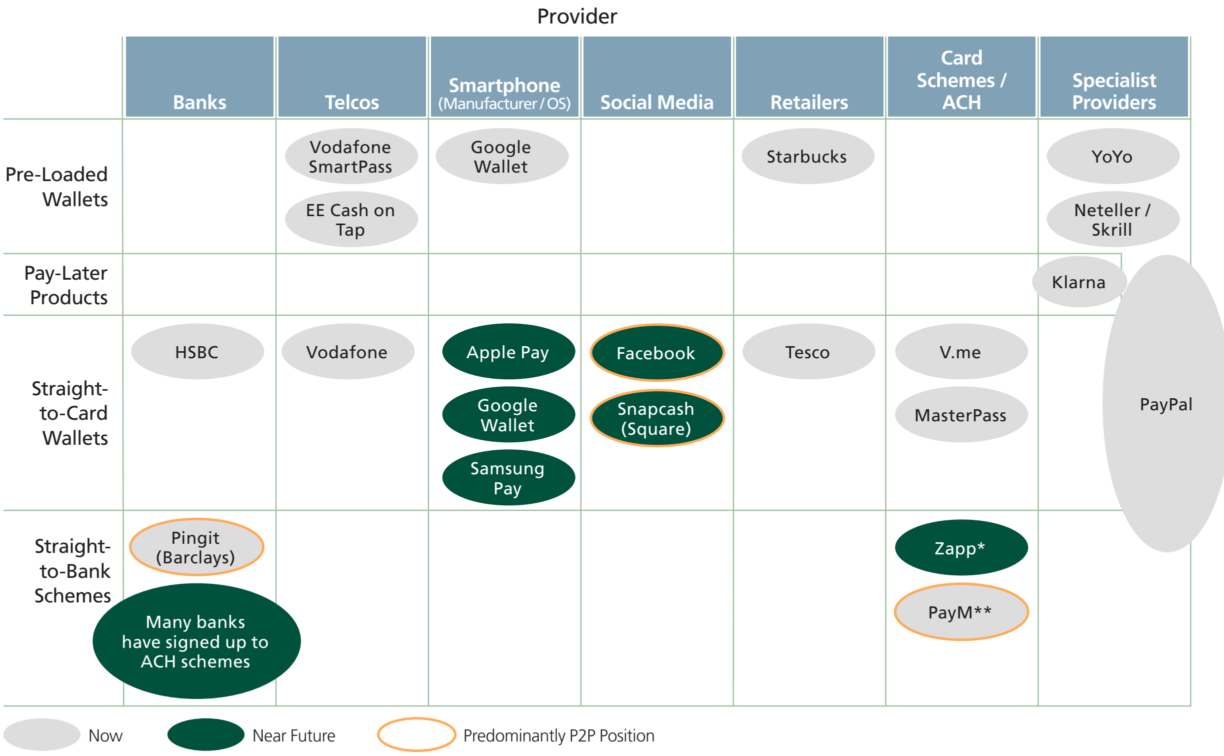
There are opportunities in the first two steps, but these often come with high levels of risk. For example, consumers may adopt a number of emerging e-wallet / mobile payments solutions as a replacement for debit and credit cards (see Figure 2), but there is considerable uncertainty about "steady state" adoption levels and about which solutions will achieve strong network effects.

Meanwhile, stand-alone processing activity (step 4 in the value chain) is becoming increasingly commoditized and low-margin, with major processors such as First Data and Global Payments responding by diversifying their activities and providing more value-added services to merchants.

In our view, the most attractive opportunities for PE investors are therefore in areas that (1) are as close to the merchant as possible (the stronger the relationship, the less vulnerable it is to disintermediation); (2) involve services and platforms that will continue to be relevant as the industry changes and new

Figure 2

UK E-Wallet/Mobile Payments Landscape



Note: * Zapp is in partnership with First Direct, Nationwide, HSBC, Santander, Barclays and Metro Bank ** PayM is in partnership with most major UK banks

Source: L.E.K. analysis

technologies emerge; and finally (3) are not pure scale plays where returns are mostly determined by low processing costs.

We have identified three kinds of payment business models that are good examples of opportunities that meet these criteria.

1. **Payment Solutions Providers.** These are businesses that are "prime" to merchants and deliver multi-platform payment solutions and associated value-added services. The key assets of these businesses are their relationships with merchants, underpinned by their ability to integrate payment acceptance with internal systems (such as ERP) and offer analytics such as a "one customer" view across different channels. This creates higher "stickiness" and reduces the likelihood of the solutions provider being displaced. There are many examples of such providers, for instance The Logic Group in the U.K. (recently acquired by Barclaycard) offers a proposition anchored in a number of integrated services:

- Delivering payment processing across platforms and channels (e.g., point-of-sale, e-commerce, and MOTO)
- Addressing needs beyond payments, particularly loyalty schemes and customer analytics
- Providing value-added services for international shoppers (such as VAT refund and dynamic currency conversion), which are also margin-enhancing for the merchant
- Enabling acceptance of emergent payment methods and local schemes for key international target markets
- Ensuring a fully secure and compliant payments environment

We believe that there are growth opportunities for this model. For example, increasing merchant internationalization creates an investment thesis for pan-

European payment solutions providers, which currently tend to be limited to e-commerce rather than PoS presence.

There are also opportunities for solutions providers to work closely with retailers on innovative store models and payment solutions, for example, those targeted at high friction payment environments (e.g., pre-order and pay-at-table solutions for restaurants and pub chains) or low volume environments with a sophisticated customer experience (e.g., tablet-based payment solutions for luxury goods retailers). Innovation is also possible in e- and m-commerce, for example, through further streamlining of customer checkout processes and the provision of finance solutions for the retailer to offer the consumer (e.g. Klarna in Scandinavia, Pay4Later in the U.K.).

2. **Business Service Providers for Small Merchants**. Multi-service providers, or introducers, focus on small businesses typically underserved by service providers such as merchant acquirers. While small businesses currently have numerous options in this area, most are very expensive and service levels are generally low.

   A successful concept needs to offer a broad range of related services that can be cross-sold to the same customer, with aggregate volumes generating enough scale to drive attractive returns. These services can include the different elements of a point-of-sale solution (till, payment terminal, acquiring services, etc.) plus other non-payment services (e.g., broadband, utilities).

   The concept of a multi-service provider for small businesses has been introduced in the U.K., for example, by XLN Business Services and Unicom, both of which have been PE-owned. There may be opportunities to expand the concept to other markets, for instance where existing platforms (e.g., bill payment providers) may already be serving a large base of merchants to which payment acceptance and other services can be cross-sold.

   The competitive response of acquirers is not likely to be strong because small businesses have historically not been a focus, although there is potential competition from emerging players targeting the small business market with innovative payment solutions (e.g.,iZettle, Payleven).

3. **Specialist Value-Added Service Providers.** A third option for PE is to enter a space directly linked to a specific trend. Two good examples are international payments (for example, SME business payments) and specialist services targeted at international shoppers such as Dynamic Currency Conversion (DCC), which enables consumers to pay in their own currency.

   In many cases, businesses offering specialist value-added services do not have direct relationships with consumers or merchants and their model is often platform-dependent. For instance, DCC provision is embedded into the traditional electronic payments value chain and is subject to disruption by, for example, e-wallet providers such as Apple Pay.

   However there are a number of positive factors underpinning the investment thesis. Specialist value-added services providers give direct exposure to a positive macro story and the niches where they operate may expand to emerging platforms, e.g. DCC is applicable in e-commerce and ATMs in addition to point-of-sale. There are also international roll-out opportunities, such as expanding DCC to Latin America, Africa and some areas of Asia. The key issue for investors is the quality of the target asset: being certain that it has superior technology, platform flexibility, customer relationships and routes to market.

The Sweet Spot for PE Investment

In some circumstances, PE sponsors are well positioned to execute deals in the payments space and may be advantaged versus strategic investors - with the right angles. They tend to have an edge in three types of situations.

1. **Scaling up a proven business model:** The recent acquisition of Moneycorp by Bridgepoint is a good example, with international expansion being an important part of the investment thesis
2. **Operational improvement:** PE investors in the major VAT

refund operators have focused on continued digitization of business processes, which make these operators more attractive potential acquisition targets for large payment processing platforms in the future

3. **"Difficult" situations, such as carve-outs or significant changes in business model:** For example, processors and acquiring businesses within banks are often unloved by their owners, making them attractive candidates for a carve-out.

   Certain parts of the payments value chain, such as Automated Clearing Houses (ACHs), have historically been bank-owned but some regulators have recently been open to changes in ownership and business model. A good example is the transition of Nets, a large Scandinavian processor, from a bank-owned model to PE ownership (Bain Capital and Advent International). Such a transition creates significant implications for commercial and pricing policies as well as the development of new services.

In an environment of growing investor interest in payments and fintech more broadly, we believe that there are opportunities for PE to target attractive investment opportunities without taking on excessive levels of risk. Investors who assess each situation to mitigate the risks and determine the value-add of PE ownership can compete successfully against strategic investors in this fast-moving industry.

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