Merchant acquiring: The rise of merchant services

The shift to electronic transactions has placed front and center the need for merchant acquiring companies to update and differentiate their service offerings.

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Globally, merchant acquiring has evolved over the past decade from a legacy processing and hardware business to a full-stack software and merchant-services solution. This shift, coupled with the fragmentation of the merchant-facing payments value chain, is dramatically affecting the economics and business models of merchant acquisition as it was done in the past, favoring instead the value-added approach of the new merchant-services players.

The evolution of merchant services typically involves a pattern in which revenues from merchant processing are being commoditized, and in response, players seek to differentiate, either by expanding their product suite or by building scale—mostly through acquisitions—across geographies, distribution (e.g., integrated software vendors, bank led), and delivery channels (e.g., digital, point of sale). Although the trends and trajectory are similar across regions, certain geographies are further ahead. As acquirers shape their priorities for the next decade, the transformations spurred by 2020's public-health crisis will play a big part in the way they rethink their vertical focus, platform strategy, and investment priorities.

New winners and complex needs compel a reevaluation of focus and value propositions

As detailed in Chapter 1, one of the COVID-19 pandemic's most visible impacts on financial services has been the dramatic acceleration in shifts toward e-commerce and digital payments. This is true not only in more mainstream verticals, such as fashion and groceries, but also in merchant segments like healthcare, professional services, and education, which historically have not received a material portion of payments through B2C digital channels.

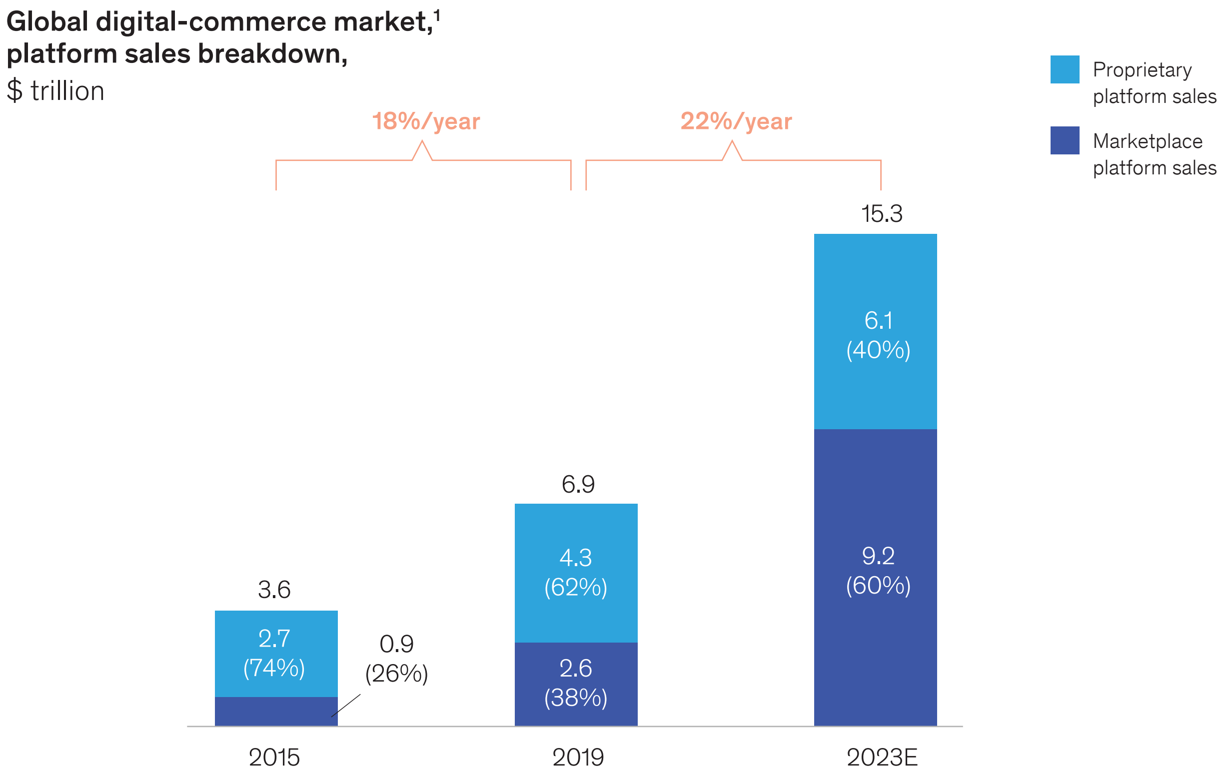
This has led to an unprecedented digitization of small-business commerce across geographies, mostly through marketplace platforms. Marketplace Platforms like Amazon, eBay, Etsy, Flipkart, and Shopify have seen seller sign-ups increase by 70 to 150 percent since the start of the pandemic, based on their most recent filings and public statements (Exhibit 1), while proprietary platforms are losing share. In healthcare, there has been a surge in provider participation for services like telemedicine, which in turn is highlighting a growing need for B2C digital payments in professional services, education, and other areas.

This shift to digital is driving up merchants' payments-acceptance costs, which are expected to rise by an incremental \$8 billion to \$15 billion (about 6 to 10 percent) as commerce migrates to these higher-cost channels. Just as importantly, merchants also face higher decline and fraud rates on digital transactions, with ramifications for customer experience.

As these at-scale marketplaces and platforms consolidate their share of digital sales, they naturally seek to lower their cost of acceptance, which in turn adversely impacts margins for acquirers. At the same time, however, digitization of commerce has created greater willingness to pay for enhanced services and solutions. Merchants are willing to accept higher fees for demonstrated value, such as improved authorization rates, a more seamless payments experience, or improved cart conversion through point-of-sale financing. Even in sectors like grocery, where acquirer margins have approached

Exhibit 1

Digital marketplaces are expected to account for about 60 percent of digital-commerce volume in the next few years.



[1] Includes retail; travel, media, and entertainment; food and beverages; bill payments; and others.
Source: McKinsey Global Payments Map; McKinsey Digital Commerce Benchmark

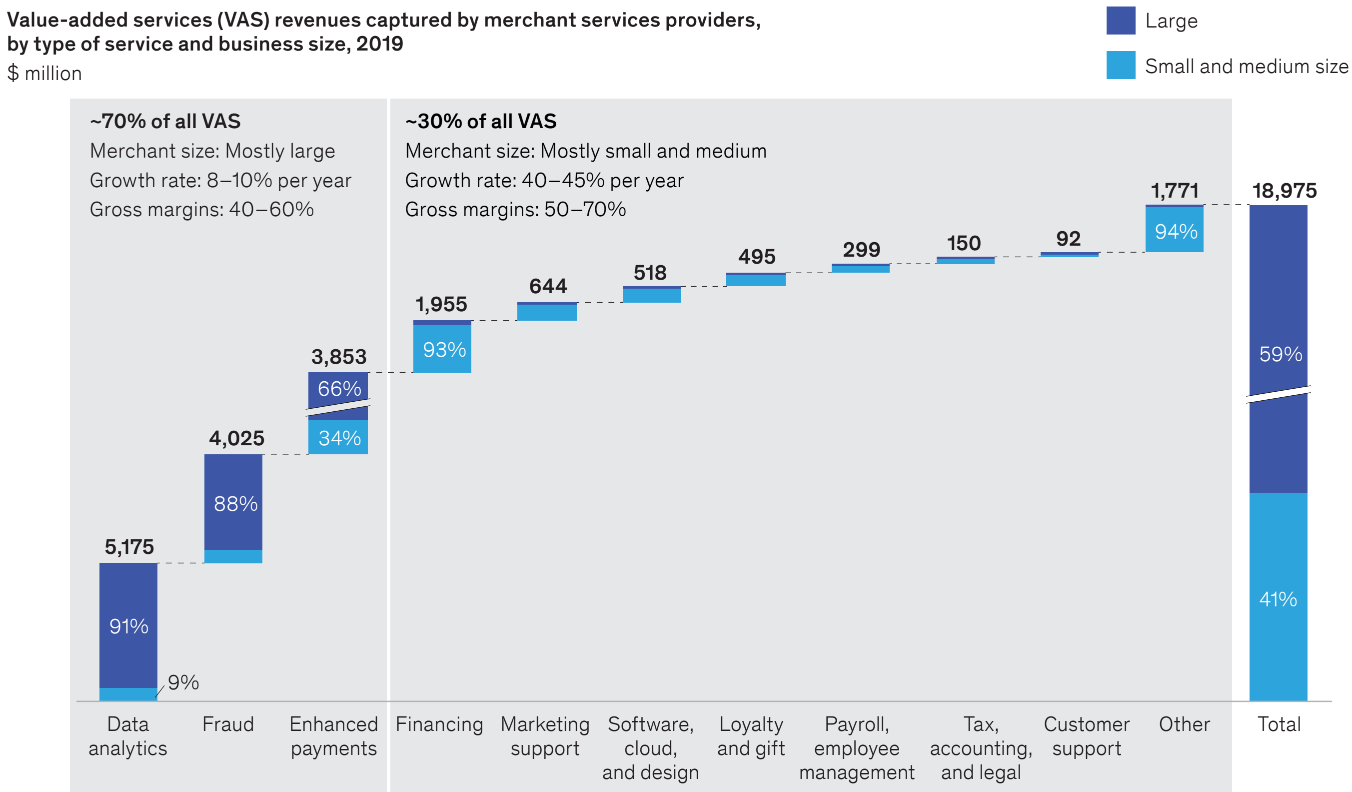
structural floors over the past few years, merchants are willing to pay 20 to 30 percent higher rates for better payments performance, particularly when the impact on the business is positive and significant. Higher-margin verticals, such as fashion and accessories, are seeing increased demand for financing solutions and affiliate marketing products. As an example, within the fashion and accessories verticals in the United States, the number of merchants signed up for buy-now, pay-later solutions has nearly tripled.

Leading acquirers are starting to transform in two distinct directions: adding targeted value propositions and becoming marketplaces themselves. Industry-focused value propositions address market needs for service and risk levels, fees, value-added features, partnerships, and back-end integration. This approach is not necessarily industry specific; acquirers are increasingly segmenting industries into groups based on specific needs, such as a pay-later segment, delivery segment, prebook segment, and repeat-visit segment. Just as importantly, acquirers themselves are beginning to resemble marketplaces by offering solutions like payments disbursement, financing and onboarding for small and medium-size enterprises (SMEs), commerce marketplace know-your-customer services, sub-merchant account creation and management, and SME-facing risk and identity solutions.

Most large acquirers have invested heavily in core payment-enablement services like authentication, fraud, and alternative-payment-method (APM) acceptance and in creating omnichannel acceptance and settlement, but relatively few have capitalized on the opportunity to deliver enhanced value-added services to large retailers (Exhibit 2). Given the growing willingness of large retailers to pay for such services and to seek these from their current providers, this is a significant opportunity for current portfolio monetization and margin protection. The focus of these investments in add-on services will be influenced by the vertical focus of each merchant-services provider.

Exhibit 2

Small and medium-size enterprises are contributing to a growing share of value-added services in payments revenue.



Source: McKinsey Payments Practice

Acquisitions have helped build geographic and capability scale, but not solution scale

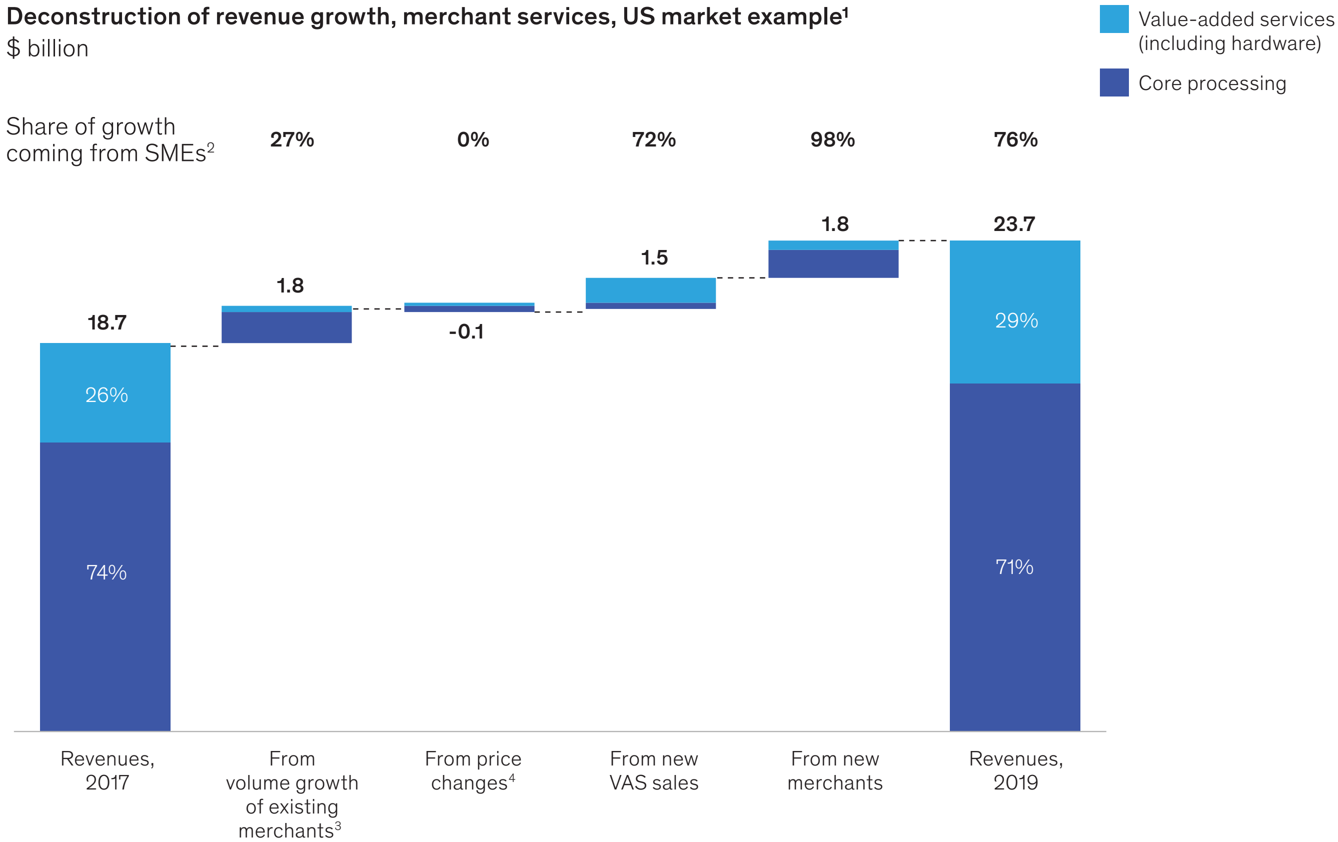
The consolidation in merchant acquiring over the past several years has enabled acquirers to build scale across geographies and to enhance their suite of capabilities to stay competitive in the face of next-generation merchant-services platforms, including Adyen, Checkout.com, and Stripe. However, this spate of acquisitions has also led to acquirers being laden with numerous regional, duplicative, and subscale solutions, adding to technology overhead. Over time, this will impede efficiency and interfere with acquirers' ability to serve multi-geography merchants, especially in digital segments. Some of the largest acquirers are saddled with 12 to 15 different regional gateways or platforms that leave them, unlike next-generation acquirers, ill-equipped to offer their clients an at-scale, multi-geography solution.

Although continued consolidation is likely, an increasingly important tactic is for acquirers to invest in building a set of scalable solutions fit for purpose for priority merchant segments. As margins on traditional payments services continue to be compressed, solution scalability will become increasingly critical to sustain the business's economic viability.

In addition to the scalability of solutions, significant untapped opportunity lies in enhancing the scalability and sophistication of data infrastructure to enable targeted use cases around enhanced authorization, fraud, and performance-based payments arrangements. For example, payments-services providers are offering performance-based arrangements that include authorization warranties, which are fee constructs linked to fraud reduction based on advanced analytics.

Exhibit 3

Most revenue growth in merchant services is from small and medium-size enterprises.



[1] Total excludes network assessment fees.
[2] Small and medium-size enterprises, classified as businesses with <$100 million in revenues or sales where the cost of payments acceptance is directly borne by the SME; excludes marketplace-like models that do not directly pass on acceptance costs.
[3] Growth from underlying growth in sales; value-added service revenues attributed to services linked to processing a transaction but sold separately (eg, enhanced authorization).
[4] Growth linked to price changes. Recent pricing pressure has led to price declines.
Source: McKinsey Payments Practice

The acceleration of SME digitization has further underscored the value in the long tail

Even prior to COVID-19, most of merchant-services providers' revenue growth came from the long tail of SME customers. Most acquirers have targeted this opportunity through indirect distribution channels (e.g., integrated software vendors and web-store providers), as scaling through direct channels poses a more complex challenge. In markets with bank-owned acquirers, this transition to indirect channels has been slower, given the ability of bank-owned acquirers to sell directly within their own base.

Regardless of the channel, however, SMEs have accounted for about three-quarters of all new revenue growth in the merchant-services space over the past three years, especially in established markets (Exhibit 3). Serving SMBs requires hyperregional strategies for distribution and scale.

In mature markets, acquirers are increasingly focusing on distribution through ISOs (independent sales organizations), ISVs (integrated software vendors), and other indirect channels, relinquishing 40 to 80 percent of revenue margins as residuals to their channel partners. As COVID-19 has accelerated a flight to digital for SMEs across verticals, some of banks' ISV-led models have been taken a financial hit. Within the restaurant space, for example, at-scale food-delivery apps like Just Eats, Uber Eats, and Zomato have gained scale, and transaction volume has shifted from the in-store ISV to the food-delivery applications, meaning those transactions are no longer processed by the restaurant's acquirer or processor. Under those conditions, acquirers need to rethink their approach to partnerships and develop models that deliver more value to merchants through their ISV partners—for instance, merchant cash advances, point-of-sale financing solutions, analytics, and omnichannel reconciliation.

In emerging markets, ISVs are steadily gaining share, but most of the sales still leverage traditional agent-based or direct models. Bank-owned acquirers have an advantage in many of these markets but often lag in sales and product sophistication. In these markets, acquirers still have the opportunity to invest in building a point-of-sale platform-based business that enables them to serve a broad swathe of merchant needs and monetize the SME relationship in a more holistic fashion.

Trade barriers and government intervention hinder market expansion and enable local wins

The economic slowdown has increased many governments' willingness to accept additional investment avenues, somewhat counterbalancing the impact of recent trade disputes. The competing priorities of regional governments are likely to interfere with companies' ability to enter into new markets organically. Acquirers will need to consider regional sponsorships, acquisitions, or joint ventures to enter priority markets.

This "slow-balization" is also expected to fuel the growth of regional supply chains. This will create a need for regionally integrated solutions, especially in B2B payments. Acquirers that have been slower to pursue the value pools in B2B digital commerce, due to its multi-geography complexities, may now be able to pursue opportunities at a regional level.

Preparing for 2021 and beyond

As acquirers and merchant-services players reorient to prepare for the next decade, several key areas require focus:

- *Investing to transform into a platform business for larger merchants.* Most large merchants are grappling with the accelerated shift to e-commerce, which has created more pronounced payments digitization needs at the point of sale, including contactless payments, enhanced authorization, fraud and chargeback mitigation solutions, financing at point of sale, sub-merchant onboarding, and payments remittances. Acquirers have a unique opportunity to shift from being a traditional payments acquirer or processor and bring together proprietary and partner solutions into a single platform for larger merchants, which also enables bundled economics and better value creation.
- *Investing in SME channels in emerging geographies to capture share.* The shift toward ISV-led models across markets is imminent; acquirers need to assess their strategic posture to address this trend. The build-out and scaling of direct-to-SME models will be capital intensive but potentially more lucrative if acquirers can create SME-focused one-stop-shop platforms. Investing in these channels and value propositions over the next 18 to 36 months, before these markets tilt toward ISV-led models, will position them to compete much more effectively.
- *"De-cluttering"* infrastructure. The spate of acquisitions has led to often redundant data and software platforms that are burdening at-scale merchant acquirers, hindering their ability to compete with next-generation players that have built more integrated, scalable solutions. There is a dramatic need for rationalization of software, data platforms, infrastructure, etc. to enable acquirers to support merchants efficiently across geographies, verticals, and devices.
- *Aligning and simplifying organizations to mirror emerging and at-scale merchant profit pools and needs.* Segmenting customers into enterprise (and within this marketplace models, pure-play subscription, travel, at-scale retail) and SMEs (and within this direct, bank-led, ISO/ISV/VAR led, partner-led) and organizing the business around segments based on how customers buy is critical to compete effectively. Such alignment will enable acquirers to invest appropriately in sales effectiveness and commercial enablement, thereby improving go-to-market and pricing approaches as well as progress tracking.
- *Directing investments to digital ISVs and payments-adjacent offerings.* With traditional processing revenues under sustained pressure, acquirers should focus investment on scaling integrations with digital ISVs and creating payments-adjacent offerings where they have a value-added play (e.g., POS financing, rewards redemption at point of sale, SME financing) Acquirers should better monetize their role within the value chain as an enabler between

issuers/service providers and merchants, e.g., explore the material opportunity to act like a marketplace or and "app-store."

- *Differentiating through data.* Differentiate solutions on data and monetize data more effectively to enable enhanced authentication, fraud, and chargeback use cases. The shift to digital has created a much greater demand for enhanced authorization, real-time data connectivity, better data-enabled fraud, sub-merchant underwriting decisions etc. Acquirers possess a gold mine of data but the complexity of disparate platforms, unclear data strategy, poor data architecture, and limited build-out capabilities have impaired the ability to effectively monetize this asset.
- *Avoiding complacency on alternative payment methods.* The growth of APMs, fueled by evolving regulation, ongoing innovation and retailer interest, will necessitate their inclusion in acquirer portfolios. APM strategies must evolve to a point where acquirers have a clear view on when and how to directly integrate vs. license through APM aggregators or other consolidators. In addition, as APMs capture a growing share of transactions, acquirers will need to refine pricing/revenue/fraud models to drive value.
- *Rationalizing customer processes.* As the number of devices, interfaces, payment means, and channels continues to increase, acquirers are in a privileged position to aggregate, triage, and monetize a "guaranteed best route" experience. A customer journey-based view of payments evolution is critical to its enablement.

The merchant acquiring industry will likely see continued consolidation on the acquiring side and sustained fragmentation on the distribution side. Growing commoditization of processing will need to be offset by improved sophistication of solutions and enhanced back-end efficiencies. Competing effectively will require scale not just across geographies and verticals but across solutions as well. As merchants across sectors rethink their acceptance and payments needs and journeys post-COVID-19, the acquirers who orient themselves to innovate around these needs and journeys are best positioned to win.

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